FEDERAL OPEN MARKET COMMITTEE MEETING TRANSCRIPTS

Prefatorv Note

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Meeting of the Federal Open Market Committee

December 19, 1995

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, December 19, 1995, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Blinder
Mr. Hoenig
Mr. Kelley
Mr. Lindsey
Mr. Melzer
Ms. Minehan
Mr. Moskow
Ms. Phillips
Ms. Yellen

Messrs. Boehne, Jordan, McTeer, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus and Parry, Presidents of the Federal Reserve Banks of Richmond and San Francisco, respectively

Mr. Guynn, President elect, Federal Reserve Bank of Atlanta

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Ms. Browne, Messrs. Davis, Dewald, Lindsey, Mishkin, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Mr. Madigan, Associate Director, Division of Monetary Affairs, Board of Governors
Mr. Simpson, Associate Director, Division of Research and Statistics, Board of Governors
Mr. Ramm, 1/ Section Chief, Division of Research and Statistics, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Beebe, Goodfriend, Lang, Rosenblum, and and Sniderman, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Richmond, Philadelphia, Dallas, and Cleveland, respectively
Ms. Rosenbaum, Vice President, Federal Reserve Bank of Atlanta
Ms. Perelmuter, Assistant Vice President, Federal Reserve Bank of New York
Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis
Mr. Evans, Senior Economist, Federal Reserve Bank of Chicago

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1. Did not attend portion of meeting covering the monetary policy discussion.

Transcript of Federal Open Market Committee Meeting
December 19, 1995

CHAIRMAN GREENSPAN. On behalf of all of us, I want to welcome Jack Guynn.

MR. GUYNN. Thank you very much.

CHAIRMAN GREENSPAN. Jack is a veteran of the Fed who needs no introduction.

To start off, would somebody like to move the minutes for the November 15 meeting?

VICE CHAIRMAN MCDONOUGH. So move.

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection. We need acceptance of the Report of Examination of the System Open Market Account. It has been distributed. Any questions? If not, would somebody like to move it?

SEVERAL. So move.

CHAIRMAN GREENSPAN. Without objection. I now call on Peter Fisher.

MR. FISHER. Thank you, Mr. Chairman. I would like to begin with the Mexican swap renewal before turning to the market reports. All of this is summarized on the one-page outline of my report that you have before you. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions? Yes, Larry.

MR. LINDSEY. Peter, would you refresh my memory as to why we increased the Mexican swap line from $1-1/2 to $3 billion last February 1?

MR. FISHER. That was part of the package.

MR. TRUMAN. Remember, there was a first phase whereby the Committee initially activated the existing $3 billion. Then, at the end of December 1994, there was an effort to deal with this problem in what I sometimes call the "old fashioned" way by getting banks together and so on. The Committee approved a "temporary" swap line of $1.5 billion in conjunction with the arrangement that included $5 billion provided by the BIS. Then, the Committee went up to the $3 billion temporary line in the context of the President's second program.

MR. LINDSEY. But we are now getting out of the second program?

MR. TRUMAN. Right.

MR. LINDSEY. So, why are we not taking our level of commitment back down to $1-1/2 billion?

MR. TRUMAN. The original $3 billion was associated with the regular program.

MR. FISHER. There are two $3 billion swap arrangements; think of it that way. There is the basic $3 billion, which was what we already had in place. Then we added a supplemental one last December of $1.5 billion, which was increased to $3 billion on February 1. It's just a coincidence that it was $3 billion. Now, we are letting that whole supplemental arrangement expire, and we are going back to the original, regular $3 billion.

MR. TRUMAN. The other part of the confusion is that the Treasury also has a $3 billion swap line with the Mexicans.

MR. FISHER. There are lots of threes.

MR. TRUMAN. Too many threes around here.

CHAIRMAN GREENSPAN. Further questions for Peter? Cathy.

MS. MINEHAN. Just a couple of factual questions: The $650 million is from the regular swap line or from the temporary one that was part of the program to help Mexico last year?

MR. FISHER. It's drawn under the regular swap line. They never drew enough to get into the supplemental or temporary $3 billion.

MS. MINEHAN. Is it a function of our regular swap program that we are repaid by the Department of the Treasury?

MR. TRUMAN. One of the conditions for the Committee's approval of the Mexican drawings was that we would be repaid either way--that is, by the Mexicans or by the U.S. Treasury.

MS. MINEHAN. The Treasury would repay us, if necessary, under either program on any part of the $6 billion?

MR. TRUMAN. I think it was just an accounting convenience that we assigned these drawings to their regular swap line. We could have done it the other way around; it might have been somewhat more logical.

MS. MINEHAN. I just wanted to understand that. Secondly, the North American Framework Agreement (NAFA) was to provide a forum, according to footnote 2 in your memo, for more regular consultations on economic and financial developments. Has that worked?

MR. TRUMAN. My view is that it has worked, though maybe not as well as it should have. In particular, there have been stepped up consultations at all levels among all three countries, some bilateral and some trilateral. I think in fact one of the most useful things that was done--the only thing I think we did right--was that Peter arranged to have a weekly conference call with the Canadians and the Mexicans, which allows us to do a once-a-week update of economic and financial conditions in the three countries. That regular weekly call has meant that it is therefore much easier to have ad hoc contacts. So, that is one element that has come out of this process.

MS. MINEHAN. Combining that with the additional transparency that the IMF obtained from the Mexicans in terms of some of their data reporting, do we feel that we would not have been in the situation that we seemed to be in earlier in terms of our knowledge of how much their reserves were being depleted?

MR. TRUMAN. The capacity of central banks to manipulate their reserves is quite substantial, but even in 1994 I think we had a pretty good fix on their reserves, though we may not have kept the Committee as well informed as we should have.

MS. MINEHAN. It is 1994 that I was getting at.

MR. FISHER. I think you need to separate the question of whether the market had a good sense of a number of data points from their balance sheet and macroeconomics and whether we had good information about their reserves. There were only a very few days in December 1994 when we were, I think, at a loss and a little anxious about what their reserve levels were. But I don't think, if you take 1994 as a whole, that we had a sense that we weren't getting a good level of cooperation and understanding of what their reserve balances were. That's internally. That's different from the public issue that I think the IMF was addressing.

MR. TRUMAN. The one thing that has happened since we circulated Steve Kamin's memo is that they have adopted a new framework for their monetary policy. This is not a big deal, but they have adopted more conventional definitions of their domestic assets and international reserves than they used in the past. I think this will facilitate market analysis of their operations. I don't think it avoids the possibility that the market may still misinterpret developments in Mexico, but I think the warning flag is quite substantial. It remains true that the capacity for the Mexicans, or any government, to try to slip things through is still there.

MS. MINEHAN. I wasn't so concerned about whether the market knew. I was more concerned about whether we know in a timely way.

MR. TRUMAN. Partly because of these calls that Peter has arranged and other contacts, we are much more informed than we were. We can't avoid all surprises.

MS. MINEHAN. A final question: There is an implication in your memo that while we will approve this renewal, we won't necessarily be receptive to letting them use this swap arrangement for a number of different reasons. Is that a wrong implication to draw from this memo?

MR. TRUMAN. I think that's the right implication and inference, if I may put it that way. I can't speak for the Committee. We did have a visitor last Friday from the research directorate of the Bank of Mexico. I went over both the fact that we would not renew the $650 million drawing and that that was a matter for him to take up with the United States Treasury. I also told him that the Committee was going to consider this matter today but that, all things considered, there was not a lot of FOMC appetite for new Mexican drawings in 1996. He said that was certainly the basis on which they were operating. His view is that of only one reasonably important

Mexican official on the subject, but I think he was very forthcoming on that.

MS. MINEHAN. So they don't expect to use the swap facility either.

MR. TRUMAN. That's one of the reasons why I think their preferred position would be for the Treasury to roll over the two drawings. They have a $650 million short-term swap outstanding with the Treasury too, and I think the Mexican position would be that they would like to roll the two together into a medium-term obligation to provide themselves a bit of a cushion, given that the door is going to be closed later in 1996.

MS. MINEHAN. Yes.

MR. TRUMAN. Certainly that's their position; I think that's a logical position as well.

MS. MINEHAN. The sole roadblock is this certification issue?

MR. TRUMAN. I don't know whether that's the sole roadblock, but that's an issue that we wanted to surface. The staff felt that it was a little arcane, and I apologize that the memo may not have been clear. The truth of the matter is that even absent that issue, given everything else going on, the objective of the program was basically to get Mexico's financial situation stabilized, and that has been achieved. Now, whether they will be able to move from that to what they need to do in terms of growth is a different matter. We can't do that for them. I think the general attitude is that we have done what we can.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Alan, I have a general question about whether we are going to look at these swap arrangements in any broad and organized fashion. I know you have mentioned before and others have said here that, in the foreign exchange markets in which we operate today, these arrangements are of questionable usefulness and ought to be reexamined. I don't think we can single out this one with Mexico. I think we need to look at all of them together. My question is: Are there any plans to do that?

CHAIRMAN GREENSPAN. The answer is "yes."

MR. MELZER. Okay. Will that involve discussions with counterparties in general about foreign exchange intervention and the support facilities?

CHAIRMAN GREENSPAN. I think we should first discuss it amongst ourselves here before we decide to involve anyone else. The ideal solution to this obviously anachronistic setup is not necessarily to abandon all such arrangements because they are being employed as a means of linking us with other central banks, but to replace them with something that reflects more relevant considerations in the market. We would not expand the swap arrangements, but we would do something different to maintain our relationships internationally and bring this process up to the latter part of the 20th century rather than the middle part.

MR. MELZER. The other issue that I think is difficult is that swap lines to developing countries can be troublesome. I know that we have North American trade considerations. However, as we learned in this case, what was intended for one purpose in effect drags us directly or indirectly into what I would characterize as intermediate- to long-term financing to support debt restructuring. I don't think that's our role. As I have mentioned before, I think it potentially raises questions about the independence of a central bank.

CHAIRMAN GREENSPAN. I am not as worried as you are about the independence question, but I certainly agree that what we have serves no economic or financial purpose of which I am aware. President Broaddus.

MR. BROADDUS. Under the current arrangement, we have an agreement with the Treasury that they will take us out if the Mexicans don't pay back the current drawing. I may be mistaken, and this is just a point of clarification, but I seem to have read or heard somewhere that if we renew the swap line and if there is a drawing despite our current intentions, the Treasury could not make a comparable commitment to take us out in the future on such a drawing because of some piece of legislation. Is that right?

MR. TRUMAN. As was outlined in the memo, the Treasury is subject to the certification process of the Mexican Debt Disclosure Act. In addition, the Treasury appropriation for fiscal year 1996 contains a provision that limits the extent to which they can use the ESF for operations without Congressional approval. Since they may take over our portion of the Mexican drawings, that could mean they would be using the ESF for more than $1 billion and for longer than 60 days. So, they would be constrained in terms of taking us out of further Mexican swap drawings. Coming back to President Minehan's question, that is one of the reasons why it's unlikely that the Treasury will want to get into this right away once disbursements under the President's program come to an end. Since they could not be our partner, we would be less likely to want to do something on our own than we might have been in the past.

MR. FISHER. I think it's important to keep in mind that we have not thought of Treasury takeouts as the presumption under which we have swap lines. It was a presumption under which the Committee undertook this drawing in the set of circumstances that existed in January, including the President's program, but reliance on Treasury takeouts has not been a presumption for the existence of swap lines.

MR. BROADDUS. I am focusing specifically on whether there could be a Treasury takeout if the current arrangement were continued and a further drawing were made.

MR. TRUMAN. There would have to be an assured means of repayment for any drawing under the general arrangements. Actually, the Mexican Debt Disclosure Act has a provision requiring an assured means of repayment in our case. So, we would have to have some sense of how the System was going to get repaid in any case. In the particular circumstances that Mexico was in, we were getting involved at least indirectly in a medium-term program and the Committee felt that stretching the maturity to 12 months was about as far--maybe further for some members--as it could be stretched in terms of our normal financial operations.

CHAIRMAN GREENSPAN. Any further questions for either gentleman?

VICE CHAIRMAN MCDONOUGH. I move approval of the $3 billion swap line renewal, Mr. Chairman.

CHAIRMAN GREENSPAN. Is there a second?

SEVERAL. Second.

CHAIRMAN GREENSPAN. Without objection. Would you like to continue on, Peter?

MR. FISHER. Thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Peter?

MR. MELZER. Peter, you mentioned that the bond market was selling off further this morning. What is it doing now?

MR. FISHER. The long bond is at 6.22 percent, I think, so it is backing up a bit. The middle of the maturity range is also backing up.

MR. KOHN. There was more news on the budget and, as I understand it, more pessimism about the prospects for an agreement.

CHAIRMAN GREENSPAN. How many 32nds was that down?

MR. KOHN. It was down about 1/2 point.

MR. FISHER. Yes, 1/2 point. In yield, the long bond traded up to 6.22 percent early overnight in Tokyo, came down to 6.18 percent, and was back up to the 6.22 - 6.24 percent range in the last hour.

CHAIRMAN GREENSPAN. (Consulting a pocket electronic market monitor) The truth is the markets are down 10/32. The cash market for the long bond is at 6.22 percent.

VICE CHAIRMAN MCDONOUGH. You are our official source on the matter of long-term bond rates! [Laughter]

CHAIRMAN GREENSPAN. With all the technology we have in this room, I can't have a little old gadget?

MR. BLINDER. It's in the transcript that you made that remark! [Laughter]

CHAIRMAN GREENSPAN. Sorry. Further questions for Peter?

VICE CHAIRMAN MCDONOUGH. I move approval of his domestic transactions.

CHAIRMAN GREENSPAN. Is there a second?

MR. KELLEY. Second.

MR. LINDSEY. Second.

CHAIRMAN GREENSPAN. Without objection. Let's move on to the staff reports. Mr. Prell.

MR. PRELL. Thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions? Vice Chairman.

VICE CHAIRMAN MCDONOUGH. This isn't a question, just a comment on the economic situation.

CHAIRMAN GREENSPAN. If there are no questions--yes, President Moskow.

MR. MOSKOW. Mike, this is a question on the Greenbook. On Page I-12, your report projected an increase of 100,000 payroll employment jobs per month over the next two years, the 1996-1997 period. This is keeping in mind that we are dealing with a forecast of close to potential output during this period. I was wondering about this 100,000 job figure. It seems low compared to figures that we have looked at. I was wondering whether you would expect that if we get to higher levels of payroll employment gains--125,000 or 150,000 new jobs per month--this would strain the economy's capacity during the forecast period.

MR. PRELL. One feature of the latest forecast is a change in our projection of labor force growth. As we have reported from time to time over the past few years, we have been surprised by the lack of rise in the labor force participation rate. The most recent observation was distinctly short of our expectations. So, we have flattened that path out considerably and have less labor force growth going forward. Now, what would happen if demand were stronger and employment were to grow faster? One possibility is that labor force participation remains on the track we are forecasting and we do get a decline in the unemployment rate relative to the path we projected and that creates some additional pressures. Alternatively, maybe at long last what we would see is a response by potential workers to the healthy demand for them, and you would see some renewed growth in labor force participation and stability in the unemployment rate. I don't think we can say what will happen with any certainty at this point, but we have made a distinct change in the trajectory of the labor force in this forecast.

CHAIRMAN GREENSPAN. Further questions for Mike? If not, Vice Chairman, do you want to start off?

VICE CHAIRMAN MCDONOUGH. Yes. The Second District continues to show slow growth essentially across the board. Retail sales for the holiday period have been quite weak in New York, although the more upscale stores like Saks Fifth Avenue have been doing reasonably well, perhaps to some degree because of the considerably higher bonuses from the financial services industry.

Our forecast for the national economy is somewhat lower than that of the Greenbook, but the general shape is similar. Under present monetary policy we have growth slowing to 2.2 percent in 1996 and 2.0 percent in 1997 as compared with 2-1/2 percent for both years in the Greenbook. Not surprisingly, inflation is a bit lower in our forecast, 2.9 percent in 1996 and 2.8 percent in 1997, with the unemployment rate rising to 5.9 percent and 6.2 percent in the two years. We have, of course, tried to produce a forecast that has the risks balanced. However, I am concerned about a number of factors that I believe slant the risks to the down side. In an atmosphere of continuing rationalization and restructurings of business, job security, especially for white-collar workers, could cause concerns that would make consumer spending lower than that in either forecast. Second, business fixed investment has held up extraordinarily well; both we and the Greenbook have it slowing down. But it is still the primary driver of growth and could be less strong, especially if consumer spending should be somewhat weaker. Third, the growth we are assuming in Canada, Mexico, Japan, and Europe is not terribly strong. But if we are wrong, I think it quite likely that growth will be weaker in those countries and not stronger. Because inflation has been lower and we believe it will continue to be lower than we thought it would be when we last adjusted monetary policy in July, we have had an effective real tightening of policy, and in our forecast this phenomenon will continue. For a central bank with a goal of price stability, a somewhat firm and firming policy may be a good and desirable thing, especially if you think as I do that an inflation rate of about 3 percent nominal--say, 2 percent real if we take out the bias in the CPI--is too high. However, I would prefer that policy not be so tight as to be a source of additional weakness to the real economy, which we consider to be the case now. We must be flexible in our policy. This year we finished tightening in February and eased slightly in July. If growth should turn out to be stronger than we or even the Greenbook suggest, clearly the Committee should evaluate that strength and what it tells us about the future; and if policy has to be adjusted, it should be adjusted. However, we generally believe that the approach to an even lower inflation rate should be opportunistic. Our policy should be slanted toward fighting inflation if it should move up; but rather than force it down at the excessive expense of real growth, we should be opportunistic in taking advantage of lower inflation when it happens.

There is a question whether the present market conditions in either the stock or bond markets should be allowed to inhibit policy. Clearly, despite the slight correction yesterday, the stock market by any historical standard is overvalued. If one relates it to dividend payout or price earnings ratio or market-to-book, it is considerably overvalued, but it has been considerably overvalued for about three years. What one isn't sure of is whether this is a phenomenon that could continue or whether a correction will take place. In any event, I don't think that the stock market should drive policy. It seems to me that the present level of the bond market, given what we have been able to do and what the market and the economy have been able to do in reducing inflation, is not unrealistic at all.

Lastly, as regards the budget debate, it seems to me the best thing we can do is to distance ourselves from the debate. I don't believe we should be punishing politicians for what we don't like or rewarding them for what we do like, but rather that monetary policy should follow an independent path. In my view, to the degree that we have opportunities to show that that path is independent, we should take advantage of them. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Thank you, Mr. Chairman. I wanted to focus on one of the points that Mike Prell made, and that is how we could interpret the likely consumption response to the rise in asset values. He was kind enough to share the regressions with me. The general story is that the marginal propensity to consume from an incremental stock market gain is about 5 percent. The macroeconomic regressions very much support that. What I would like to do today is to test that at the micro level. I asked the National Bureau of Economic Research to run the 1991 individual tax model file, which is the latest one they have up, to look at a detailed distribution of dividends received by taxpayers. I would be happy to give the detailed tables to anyone who wants them. I broke this down into five classes.

Look at Table 1, which has been distributed to you, and you can get a feel for this. The first row is zero dividends; 80 percent of taxpayers, which I call households and the terms are roughly synonymous, received no dividends at all. Another 13 percent of households received less than $1,000 in dividends, and these dividends made up about 4.4 percent of the total. As you can see, about 6 percent of households got about 30 percent of total dividends. At the very top, I broke down those people who received over $10,000 of dividends into those with less than $200,000 of adjusted gross income and those with more than $200,000 of adjusted gross income. Group 5, the high-income, high-dividend recipients make up about 230,000 households and got 30 percent of total dividends. The next thing I asked the NBER to do was to calculate after-tax adjusted gross income. They have a federal tax calculator, a state tax calculator, and a social security tax calculator. Column 3 in Table 1 shows the distribution of after-tax adjusted gross income for each of those groups. The last column is designed to get at disposable personal income in the national income and product accounts. The main ingredients that are not in AGI but are in disposable personal income are first, transfer payments, second, fringe benefits, and third, the excluded portions of dividends and interest, which generally tend to flow into 401(k) plans and other constrained vehicles.

CHAIRMAN GREENSPAN. That includes taxes?

MR. LINDSEY. No. Personal taxes and direct taxes are out of both columns three and four.

CHAIRMAN GREENSPAN. But adjusted gross income includes taxes.

MR. LINDSEY. That's true, but I computed "after tax" adjusted gross income. I started with AGI and and took out federal, state, and employee FICA taxes.

CHAIRMAN GREENSPAN. It says that on your table. I beg your pardon.

MR. LINDSEY. As you can see, it doesn't make that much difference, but I allocated that portion of disposable personal income that was not in AGI in proportion to wages and that gives me the last column. Then comes the thought experiment. Let's assume that we get a $50 billion increment to consumption, which is about 1 percent of personal outlays. That would correspond to a 5 percent marginal propensity to consume out of a trillion dollar rise in the markets, which is about the order of magnitude we are talking about. If you assume that the distribution of dividends is a rough proxy for the distribution of stock market wealth, then we can calculate for each group how much its total consumption would be expected to change. Of course, if you don't have any stocks, tough luck. If you are in group two, which includes people with less than $1,000 in dividends, then on average we would expect your household consumption to go up by $154. Maybe this can be picked up in the statistics and maybe it can't. It amounts to about 0.25 percent of disposable personal income for people in group two. Now you get to the interesting people, people in group three, which I suppose does not include me since I am in the zero category and I can't even borrow at Toys 'R Us! [Laughter] It does include my mother with her AT&T stock. There are a lot of households in that group. They might be expected to increase their consumption by $2,000 per household or about 3 percent of income. Now we get to the people who have dividends and therefore the capital gains. Again, just doing the straight apportionment, for those households making less than $200,000 but having at least $10,000 in dividends, we would expect an average increase in consumption out of stock market wealth of $14,000. It is conceivable to me that I could spend an extra $14,000 a year, but it isn't conceivable that these households would do so, given their relatively low level of disposable personal income. Remember, they are making less than $200,000, and if this is right, we would expect them to increase their consumption by almost one-fourth in order to account for that extra spending out of wealth. In category five, where everyone's income is over $200,000 and the average income is substantially higher at about $800,000, each household would have to spend an extra $65,000. They could buy two Cadillacs they otherwise would not have bought, and that would mean a 7.7 percent increase in their consumption out of disposable personal income.

The lesson that I draw from this is that, given the very narrow distribution of dividends, it would seem that the increments to wealth are relatively concentrated. Even combining those two categories, I find a 12 percent increase in spending out of stock market wealth by well-to-do individuals implausible. Therefore, I don't see how the microeconomic data support the macroeconomic estimate of $50 billion in extra consumption as a result of the rise in stock market wealth. There are other channels that could allow it to happen. I could, for example, feel happier and more secure in my job because the stock market is booming and go out and spend. There must be channels through which it operates, but I am not going to go on any longer. I have other tables to show how liquidity-constrained households are. They suggest that it would be very hard for that kind of transmission mechanism to account for a lot, particularly when saving rates are already as low as they are.

So, Mike, I have to disagree with you. I don't see the upside potential. I think we are unlikely to get an extra $50 billion in consumption out of the stock market increase.

CHAIRMAN GREENSPAN. Let me note just another channel that may or may not be relevant. Higher stock market values tend to be associated at a micro level with higher capital investment within a firm. That increase in capital investment spills through into disposable income and could have an impact that way. So, it is quite conceivable that, despite your very interesting appraisal, there is a channel that bypasses this and effectively impacts disposable personal income through all of these five categories to the extent that that is relevant. Obviously implicit in any evaluation of stock market wealth going into consumption, one would have to trace to be sure that the level of capital investment is reflecting the stock market wealth creation.

MR. LINDSEY. I think that is a very fair observation and I would be happy to use that to supplement my interpretation of the regression. The regression had labor income, capital income, transfer income, and wealth in it. So, I would expect that that would appear in that transition. The extra capital spending might feed through into higher disposable income. I think that would show up in the income numbers and not in the wealth numbers.

CHAIRMAN GREENSPAN. It does. I am just saying that if that channel is working vigorously, you could reconcile both these data and the reduced form regression of the wealth effect on consumption.

MR. LINDSEY. As I read it, the income was in the regression.

MR. BLINDER. Just a point of fact: Does the regression have labor income on the right or total income on the right?

MR. PRELL. I don't know what this particular regression is. I assume we are talking about the MPS model.

MR. BLINDER. Yes.

MR. STOCKTON. The MPS model has both labor income and property income on the right-hand side.

MR. LINDSEY. They are in there as well as the stock market.

MR. PRELL. Let me say, we are looking at net worth in the model, so that also shows up, which is the other side that you cited in passing at the end of your comments. Could I clarify one point without getting into an argument about the construction of these numbers? There is no significant wealth effect built into our forecast. If you look at the personal saving rate, there is no decline from where we have been. In essence, we pretty much neutralized this, taking into account also the debt side of the picture. That's why I characterized this as an upside risk. It doesn't take the full dimension of the model wealth effect in order to give rise to an upside risk of the sort that I was suggesting.

MR. LINDSEY. So, the consumption levels in the forecast do not reflect those from the MPS model?

MR. PRELL. No.

CHAIRMAN GREENSPAN. President Boehne.

PRESIDENT BOEHNE. Thank you, Mr. Chairman. The basic story in the Philadelphia District is essentially the same. Mainly, the region is a laggard compared to the nation. The outlook is for more of the same. Much of the laggard effect is coming from Pennsylvania; Delaware and New Jersey compare more favorably to the nation. On balance, the evidence from recent indicators is that the pace of growth in the District is slower now than it was several months ago. Retail sales in particular reflect a cautious attitude on the part of consumers. Retailers are still hopeful that the last week before Christmas will deliver them from an otherwise dismal season, but the discounting over this past weekend has been very heavy. Employment growth is quite slow in the region, even in industries like manufacturing and construction where activity is expanding. Attitudes --business attitudes in particular--are still generally positive about the outlook, but they appear to be somewhat more fluid. They could resolidify on the more positive side or they could flow more to the pessimistic side depending on how policy and other developments unfold. I have the sense that we are at one of those pivotal periods where people are less certain about where things are going and attitudes can flow either way.

Turning to the national economy, most recent economic data suggest that the expansion is decelerating some from earlier months. The extent of the deceleration is an open question. It may be that the strength of the third quarter borrowed from the fourth quarter and that the underlying strength of the economy remains intact. Or, it could mean that the underlying strength is beginning to wane. On balance, my judgment is that the downside risk to the economy has risen some since we last met. The possibility of more of an inventory overhang is higher now than a month or two ago. The strength of exports is more open to question. The economies of Canada, the U.K., and Germany may be weaker than the forecasts suggest, not to mention Mexico or Japan. While we can debate the consumer outlook, my sense is that if we are surprised, we will be surprised because consumption will be weaker rather than stronger. Also, the case that U.S. monetary policy may be inadvertently tighter is now more convincing in my judgment than it was several months ago, although that's a subject for later in the meeting.

The outlook for inflation remains about as it has been, neither accelerating nor decelerating much during the next year or so. Given that the economy is in a mature expansion phase, I think we need to remain alert to signs of accelerating inflation. However, price pressures remain remarkably subdued.

CHAIRMAN GREENSPAN. Thank you. President Parry.

MR. PARRY. Mr. Chairman, economic growth in the Twelfth District slowed this fall. California lost a considerable number of government jobs in October and November, particularly at the local government level. This job loss apparently boosted the state unemployment rate. However, private-sector growth appeared to have substantial momentum in the state. Economic activity in the State of Washington paused during the Boeing strike. Retailers there worried about slow holiday sales, as about 1 percent of the state's workforce missed paychecks from Boeing during the strike. However, under the new contract returning workers are getting a big Christmas present, a 10 percent lump sum payment that will make up the income lost earlier. Elsewhere, labor markets remain tight in much of the District. Employment growth slowed but generally continued to outpace the nation. In fact, in terms of employment growth over the past year, the District now has three of the four fastest growing states in the nation. Nevada and Utah are number one and number two, and Oregon has moved up to number four. I should also note that the Arizona economy continues to expand rapidly despite the adverse effects of the situation in Mexico. So far this year, exports to Mexico from Arizona and California have fallen 8 percent, a bit less sharply than overall U.S. exports to Mexico. Apparently, Arizona and California are providing a lot of the components and materials to Mexican maquiladora plants whose production has been increased.

Turning to the national economy, despite sluggish growth during the current quarter, our model forecast calls for real growth at a rate between 2-3/4 and 3 percent over 1996, which is somewhat higher than the Greenbook. Our structural model predicts that inflation will remain close to 3 percent over the next year or so but will eventually go up because the economy is operating at a high level. The acceleration in inflation occurs despite the fact that the policy rule in our model acts to restrict the growth of nominal GDP by raising the funds rate by a small amount late next year and follows through with further increases throughout the forecast. However, I expect that the economy will turn out somewhat weaker than the model is predicting. Surveys suggest that inflation expectations of both long and short horizons have come down about 20 to 30 basis points over the last quarter, and perhaps around 50 basis points since the beginning of this year. I believe that the behavior of financial markets is consistent with this evidence. If inflation expectations have indeed come down this much, the implication is that the real funds rate has gone up. As a consequence, policy may be somewhat more restrictive than in our forecast since the model we use is based on backward-looking expectations. Thus, both real output growth and inflation could come in somewhat lower than in our forecast. Thank you.

CHAIRMAN GREENSPAN. President Minehan.

MS. MINEHAN. Mr. Chairman, slow growth continues in New England. Nonfarm employment grew for the third straight month, although the overall gain was quite small. In total, the region's job count was up only slightly less than 1 percent over the previous year as compared with nearly 3 times that rate of growth over the 12 months prior to that. The region's unemployment rate declined to a level well below the national rate, but consumers remained wary and uncertain. Real wage growth has been negative. Consumer confidence dropped, especially in the component of that measure that looks at expectations. Retailers have felt this pressure. As one of our Beigebook contacts put it, he could not explain the fits and starts that have characterized the retail market this fall. Business is horrible one week and very strong the next. On a more upbeat note, manufacturing contacts report solid recent sales, with demand increasing for machine tools and industrial equipment, computer and electronics products, health care supplies, and a range of building products and equipment. Input prices have stabilized somewhat, and continued competitive pressures have precluded increases in output prices. Manufacturing jobs continue to decline, but employees are getting hard to find for some job vacancies that call for especially high technical skills. The market for residential real estate is neither good nor bad. Expectations of next spring's seasonal pickup are positive, given this year's decline in interest rates. In fact, if rates go any lower we could see a mini surge, at least in the three northern states and in Massachusetts where markets are stronger. Some commercial building is under way, though the improvement is spotty and confined to eastern Massachusetts. Bank lending in the District remains slower than that of the nation as a whole, with negative growth in commercial and industrial loans most recently. Consumer loan growth is somewhat erratic but generally in line with, if not stronger than, the national pace.

Finally, while the economic climate is tepid, if not cool, we are going to witness a very hot senatorial race. Bill Weld is taking on John Kerry for his Senate seat, a contest that has been labeled by such far flung media as The Economist as the battle of the blue bloods. This may augur well for Massachusetts at least until the election. As an example, since a mill burned down in Lawrence recently, to insure that displaced workers receive as much aid as possible. Their efforts have paid off according to with workers being sure they can survive until the new facility is completed.

CHAIRMAN GREENSPAN. Doesn't that create a moral hazard? [Laughter]

MS. MINEHAN. In some sense, yes! Turning to the national scene, we are very much in agreement with the Greenbook scenario. I must say that I have a lot of sympathy for the 4 or 5 points that Mike Prell mentioned as potential sources, if you will, of upside risks to the forecast. We looked at some of those and thought that there is some upside risk here but also some downside risk. Overall, though, we thought that the risks were reasonably balanced. And given where we are in terms of the tightness of labor markets and the basic underlying strength of economic growth that the Greenbook mentioned and Mike highlighted and that we also see in our forecast, this balance of risk looks pretty good and the overall forecast looks pretty good. So, we don't have much to argue about with your take on the national scene, Mike.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, there really has not been a lot of change in the quite mixed situation in our region that I reported on at the November meeting. I would have to say, however, that the broad tone of most of the anecdotal commentary we are getting is less optimistic than earlier. Looking at the District's economy sector by sector, retail activity did rise somewhat in our latest monthly District survey. But, anecdotally, it's described as quite sluggish. Retailers express their usual concern about rising household debt and consumer reluctance to spend as a consequence of that. Some of the sluggishness at the retail level is attributed to a lack of inventory, especially stocks of the more popular new model cars, but most of it is attributed to diminishing demand. Elsewhere, manufacturing activity, as indexed by shipments of new orders and so forth, has slipped somewhat lately. The textile industry, which is a very important industry in our region, is particularly weak at the moment. Finally, construction activity is very mixed in both the residential and commercial sectors in our region. New construction activity in some areas like Raleigh and the Washington/Baltimore corridor is clearly strengthening, but it's very sluggish in other regions like West Virginia. So, again, we see a very mixed, conflictive picture overall as I reported last month.

With respect to the national economy, probably for me at least the most striking point in the Greenbook this time is its expectation that the third-quarter GDP growth rate will be revised up from the already pretty robust preliminary figure to maybe as much as 5-1/2 percent on a fixed-weight basis. I guess we were supposed to get that figure this morning.

MR. PRELL. We won't get a 1987 dollar figure. The waters could be muddied in other ways, but we do think the third quarter looks stronger than it did before.

MR. BROADDUS. I am still thinking of it in terms of those 1987 figures and that would be a much, much stronger performance than I think anyone was expecting back last summer. Given that, I think a key question at this point is whether that much stronger quarterly gain will be followed by another stronger-than-anticipated performance in the current quarter. Not many people seem to expect that. Of course, the staff revised its 2.6 percent growth projection for the current quarter down to 1.9 percent in the current Greenbook. But the Greenbook also suggests that there is plenty of upside risk in that projection, even though that risk is not getting much attention these days, and Mike underlined that very eloquently in his comments this morning. In particular, as Mike said, production-worker hours have been growing at a healthy pace lately. The staff is projecting hours to be up at over a 2-1/2 percent annual rate this quarter. So, even a very small quarterly increase in productivity could on the old basis give us a growth rate in the current quarter of 3 percent at an annual rate or even higher. We have the very real possibility, it seems to me, of two consecutive relatively strong quarters despite all the pessimistic economic commentary we read about. With the economy already operating at least in the neighborhood of potential GDP, it seems to me that that should be a source of some concern.

The bottom line is that there is considerable room for forecast error on either side of the staff's 1.9 percent projection for the current quarter. From a policymaking perspective, the picture hopefully should become considerably clearer once we have some of the data for the month of December. We will be getting that information not too many days down the road.

One final comment: It disturbs me a little that the staff is still projecting an essentially flat 3 percent inflation rate through the forecast horizon ending in 1997. I am not questioning the projection. I am just stating that I don't like it very much. Since 3 percent is such a mild rate compared to our experience over the last 15-20 years, I think a lot of people--not around this table--are probably fairly comfortable with that scenario. But it's worth remembering, if I have calculated this right, that at a 3 percent annual inflation rate the price level doubles in something like 23-1/2 or 24 years. Moreover, a reasonable confidence interval around a 3 percent point forecast would certainly include at least a 3-1/2 percent rate of inflation, maybe something more than that. That's not price stability. I don't think we should be satisfied with it. In that regard, Mr. Chairman, we talked in July about the possibility of adding a longer-term inflation objective to our monetary aggregate targets to make our longer-term strategy more meaningful. I would hope that we might have an opportunity to resume or reopen that discussion when we look at longer-term issues at the next meeting.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. I have four general points to make today. The first is that the Eighth District economy continues to grow at a moderate pace. District retailers expect this holiday season to be somewhat better than last year's. About half of District auto dealers report autumn sales levels above those of last year, and to the extent sales have been damped, one often-cited factor has been shortages of popular trucks and mini vans. Industry contacts continue to report slow, steady growth, although contractions continue in the apparel, shoe manufacturing, and coal mining industries. The pace of residential construction has slowed slightly, but multifamily construction is picking up the slack in some areas. Nonresidential construction continues to be a bright spot in many parts of the District. Overall loan demand remains healthy with some signs of softening, and District banks continue to post record profits. I might mention that a couple of bankers on our board expect a possible mini mortgage refinancing boom to get started early next year. There is some evidence of that starting now. An informal survey of District contacts reveals that labor problems of various kinds, such as shortages, unqualified applicants, and retention are affecting many businesses. Reports of tight labor markets, defined as a shortage of available qualified workers, are concentrated in areas in the southern parts of the District, especially northwest and central Arkansas, northern Mississippi, and western Tennessee. Some contacts believe the shortage is so acute now that it is discouraging firms from expanding operations or setting up new operations in the affected areas. An added number of firms have begun to import foreign labor to fill positions.

My second major point is that the long-term inflation outlook is inconsistent with the Committee's price stability goals. The central concern of the FOMC should be progress toward price stability and there seems to be little public confidence that substantial gains on this front will be made anytime in the foreseeable future. Some long-term inflation forecasts with horizons of five years or more have indeed been adjusted downward over the last year. But generally these forecasts still show that market participants expect inflation at current levels well into the next century. One such forecast was released in October by the Blue Chip group. Their consensus forecast is for consumer price inflation to average about 3.2 percent annually through the year 2006. The Livingston Survey of Economists released yesterday predicts a similar 3 percent rate over the same period, while the University of Michigan Survey of Consumers has the same 3 percent figure, according to preliminary December data.

In addition, wage pressures may not remain quiescent over the next year, which is something that I think we all have been puzzled about to some extent given the reported tightness in labor markets for some time. The recent settlement with workers at Boeing was, in the view of some of our directors, surprisingly rich. As Bob Parry mentioned, it included a lump sum payment of 10 percent in the first year, a 4-1/2 percent lump sum payment in the second year, general wage increases of 3 percent in years three and four, and, I haven't been able to nail this down, but one individual mentioned to me that these general wage increases appeared to be on top of cost-of-living increases. I will have to try to nail that down. Finally, there was a major reversal on company plans to shift more medical costs to employees. They have gone from trying to shift costs on insured health care to the employee to actually paying a substantial bonus if employees opt for HMOs, and they have not shifted any costs to workers on the traditional plans. I am afraid that this settlement could be a harbinger of things to come. Stubbornly high inflation expectations and possible future wage increases have led me to view the current situation as a window of opportunity. Ed Boehne mentioned fluid expectations. I think that had to do with the real side. I would also say that expectations could be quite fluid with respect to inflation. Moves now to place downward pressure on inflation expectations might pay handsome dividends in the future. The FOMC, and I agree with what Al Broaddus said a minute ago, should develop a plan to move further toward price stability and offer markets some convincing evidence that we intend to achieve such a goal in a reasonable timeframe. I think some specific objective would go a long way in that direction.

My third major point is that the national economy seems to be growing near the post-war average. Most private forecasters predict stable and sustainable growth in real output through 1997. The Blue Chip group, for example, foresees growth of about 2-1/2 percent through the end of 1996, and a majority of respondents expect growth to continue into 1997. The unemployment rate is low and belies predictions of imminent weakness. The index of leading indicators, of course, has been falling through most of 1995, but almost all of this decline is dominated by the changes in the prices of sensitive materials. The rate of increase in these materials prices, I think, has merely been tapering off from the very rapid pace set in 1994 and in fact could be interpreted as a positive factor for the economy, not a negative. The rally in longer-term bonds is mostly good news for 1996 growth prospects. It should help the housing industry as well as business investment and may lead, as I mentioned before, to a new wave of mortgage refinancing.

My final point is that recent trends in financial markets seem consistent with continued expansion, which I think is a point Mike made earlier in his briefing. Aggregate credit remains readily available even though growth in total bank loans has slowed recently as firms have turned to longer-term capital markets. In addition, the growth in M2 since the beginning of 1995 seems consistent with an economy growing at potential. The marked runoff in total reserves over the last two years, albeit distorted by the spread of sweep accounts, is a cause for concern. On balance, however, growth in the monetary aggregates supports an expectation of continued moderate expansion in nominal GDP. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. Let me start by saying that I agree with Mike's comment that the expansion at the national level has not run out of steam and that it will continue.

As far as the Ninth District economy is concerned, it remains in pretty good shape, although the anecdotes this time around are perhaps a bit more mixed than they have been in a while, and I will comment on that. Retailers, of course, express concern. That goes with the territory to some extent. I think the concern also reflects the fact that there are simply more of them, and they are getting smaller shares of a growing market. That is part of what is going on here. Certainly, some of the large auto dealers in our District point out that a shortage of sports utility vehicles in particular is restraining sales from what they otherwise would be. I happened to be at a meeting with a variety of real estate and construction tycoons whose business is concentrated, but not exclusively, in the Twin Cities metropolitan area. They were all smiles, because 1995 was a very good year for these people, though not a record year. This included everything from single-family and multifamily developers on up through commercial construction, large-scale projects, and so forth. They seem very comfortable with the outlook for 1996. I would say that they were confident that they were going to have another good year.

As has been the case for quite some time, labor markets in the District are tight. There are shortages of skilled and unskilled workers in various parts of the District. As Tom Melzer mentioned for his District, I think the shortages are constraining expansion in some parts of our District. That also has started to translate into more signs of wage pressures than formerly was the case. It's by no means universal, but I did hear more about sizable wage increases recently than I had earlier. The principal area of concern is in manufacturing. Even those manufacturers who have had a pretty good year in 1995, and there is quite a number of them, say that orders have slowed, and they express some concern about 1996. I have a sense that inventories are higher in a large part of manufacturing than managers would like them to be. They intend, of course, to pare those back, but that implies that the manufacturing sector could remain soggy for some time. That seems to me to be the principal area of softness at the moment.

I think Mike Prell's commentary about inflation and the risks on the up side is well taken. But I wonder if there isn't an equally good case to suggest that maybe we are going to do better on inflation than the published forecasts suggest. If I wanted to make that case, I would point to the following factors. They are not additive; I will just throw them out as factors. One is a number of consecutive years of modest growth in the money supply measures. The second is my sense that productivity has done better than anticipated and probably better than measured in many cases. This is something that may well continue. Third, I think we are going to get a continuation of restrictive fiscal policy. It may be back loaded and all of that, but I think it is still likely to occur. Finally, I have a sense that more and more central banks around the world are committed to low inflation policies. Ultimately, that matters. So, I think one can make a case that the inflation outlook based on those factors may be a bit more promising than we might otherwise expect.

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, the level of economic activity in the Seventh District continues to be somewhat higher on balance than that for the nation, but the recent pattern of slowing growth seems to parallel what is happening nationally. I should note that our directors at their meeting last week expressed somewhat more concern about the District and national economies than they had in recent months. Mr. Chairman, you heard those comments firsthand by telephone.

Reports from District retailers have been mixed, with national chains continuing to report that sales at their stores located in the District generally are slightly stronger than their sales nationally. Several retailers reported that price-conscious consumers have been hesitant during this holiday shopping season, hoping to get even better deals as the season draws to a close. Promotional activity and discounting have been intense this year, as Ed Boehne mentioned, not only because consumer spending growth has slowed but also because of overcapacity in the industry, as Gary Stern mentioned. But there is one piece of good news. Some of this excess capacity in the Chicago area has been taken up by a dramatic surge in sales of anything with the name Northwestern University on it [Laughter], particularly when it has roses on it, to celebrate Northwestern's first trip to the Rose Bowl since 1949.

In the District's housing sector, which has been quite strong, home sales and starts have softened recently, in part due to the adverse weather. In contrast to a decline nationally, housing permits in our region actually moved up in October. So, our regional market may not be as soft as the October sales and starts data suggested. In terms of autos and light trucks, the situation has not changed significantly since our last meeting. This is still an area of concern. While it's too early to get a good fix on December sales, industry contacts report that the current pace is in line with or slightly higher than the November level. Despite some improvement in sales rates since October, production plans for light vehicles through the first quarter have been pared back gradually as inventories have climbed this quarter. For manufacturing generally, the momentum that was developing this fall appears to have dissipated somewhat in November. Purchasing manager surveys from around the District, for example, indicate that overall activity in the region's manufacturing sector flattened out in November after having expanded in October. However, we do have advance information on the Chicago Purchasing Managers' Index that will be released to the public at the end of December. That indicates a rebound from 49.9 in November to 57.6 in December. Again, a word of caution; that information won't be released until the end of this month. Steel shipments continue at high levels in the fourth quarter, led by demand in construction-related markets. Overall demand growth, however, has slowed in recent months. I have been talking to people in the steel industry recently and, of course, their main concern is that prices are soft in their industry, in part due to the slower growth and in part due to the new capacity that is coming on stream. Another reason that steel prices are expected to continue to be soft is that the integrated producers now have labor contracts that prevent them from laying off employees regardless of production levels. So, even if they close down blast furnaces, they still have these employees on the payroll and, of course, this encourages them to continue producing at very high levels. That contract provision was negotiated in 1993. Labor markets in the District remain tight, with unemployment rates still well below the national average, and we are still receiving some reports of rising wage pressures, especially for low-skill, entry-level jobs. Price patterns in the District do not seem to have changed much since our last meeting. Natural gas prices increased sharply with the cold weather in November and early December, but this is viewed as a short-term phenomenon.

Turning to the national picture, we see the economy growing near its potential over the next year but perhaps slightly below the Greenbook path. CPI inflation should continue around 2-3/4 percent, which is basically similar to the Greenbook assessment. This view of the economy is shared by other economists in our District who attended our ninth annual economic outlook symposium earlier this month. The median forecast of this group of 33 economists was for real GDP to increase 2.4 percent over the four quarters of 1996, the CPI to rise 2.8 percent over the same period, and unemployment to average 5.8 percent in the fourth quarter of next year.

CHAIRMAN GREENSPAN. Thank you. President McTeer.

MR. MCTEER. The economy in the Eleventh District continues to be healthy. Throughout 1995, we kept hearing that employment growth had slowed in our District and that we were converging toward the slower rate of growth in the nation as a whole. These District estimates kept being revised up. Through October, employment growth has been about 3 percent for the year, about double the rate of the country as a whole. Reports from our directors and Beigebook contacts suggest moderate to strong growth across virtually all the Dallas District. We had a joint board meeting last week of all of our offices, and the reports were quite upbeat. The directors from the major cities in Texas were competing with each other in claiming that their local economies were stronger and that they were more on the leading edge of high tech. It's been quite a while since there has been that sort of competition and optimism in our District. There were some exceptions, though. Retail is doing poorly. Agriculture has been hurt by low beef prices, especially low beef prices relative to grain prices, and by boll weevils in the cotton fields. Our areas along the Mexican border are flat overall, with weak retail results being offset by strong construction activities related to the maquiladora operations on the Mexican side of the border. These factories continue to expand as they benefit from the weak peso and the resulting low wages in dollar terms. Our friends at tell us that sales in recent weeks have been absolutely terrible, with general merchandise and apparel sales being at recession levels. My concern is that this weak performance will pass through to reduced orders, a rundown of bloated inventories, production cutbacks, and all the rest.

I fear that without some reduction of monetary restraint, the economy at the national level could run out of momentum before very long. I think our research economists would almost without exception agree with Mike Prell's five points. My instinct is that the downside risks are somewhat greater than that.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, the Tenth District economy remains strong overall, with only a couple of our directors indicating some evidence of slight slowing. Payroll employment in the District, for example, has been growing at a fairly healthy pace with gains in all our District states. Among other signs of strength, District manufacturers continue to operate at levels near or at capacity, especially in our durable goods industries. Our directors also report that retail sales appear to be holding up during the holiday season, although sales probably will grow less than they did a year ago in some areas. Finally, construction activity has been brisk throughout our District, typically the building of roads and other public infrastructure. While the economy in the Kansas City District appears to be generally strong, a few sectors are giving us some mixed signals. One of those, of course, is the farm economy, which has been helped by higher crop prices, but financial losses continue to hurt the cattle industry, which is a very important industry within our region. While oil and gas drilling activity has picked up recently, the District energy industry remains lackluster overall, with the workforce continuing to shrink somewhat.

The final point I would make on the District is that, to date at least, upward pressure on wages and prices has been limited. Labor markets remain tight in many parts of the District, but reports of rising wages, though evident, still remain scattered.

For the national economy, I believe that, given current policy, conditions are such that growth for the next several quarters will be about 2 to 2-1/2 percent and inflation will be 3 percent, perhaps a little less. In this environment, moreover, economic resources will continue to be used at or near capacity levels. A little concern has been raised here about consumer spending and fiscal drag. As for consumption, I think it certainly needs to be monitored, but I believe it can be maintained at levels consistent with the income growth projected in these GDP forecasts. Consumer debt, while it indeed has increased relative to income, is not at historical peaks, and I think it would allow consumption to continue upward. Also, if we assume that consumer debt burdens are excessive, I am not sure that monetary policy can address that issue in the longer run. As regards fiscal policy, I agree that the budget debate should not be a consideration for us. Reasonable estimates suggest, though, that the deficit reductions in 1996 are likely to be quite small. Thus, any drag on the economy from fiscal actions will be limited in the foreseeable future at least. I also would point out that lower yields in long-term debt markets have been stimulative. That suggests to me that in the context of developments in those markets our policy has been neutral and not slightly tight. Thus, overall, we have an economy slowing to potential and inflation capped at only 3 percent, and that is something that I think we should keep in mind as we go forward.

CHAIRMAN GREENSPAN. President-elect Guynn.

MR. GUYNN. Thank you, Mr. Chairman. The Southeast continues to grow at a rate that appears to be above the national average. Thus far, no sector appears to be overextended. Wage and price pressures are stable. Our District's pretty extensive manufacturers' survey shows no net movement in either input or final goods prices. The scattered labor shortages that we saw earlier this year, particularly in the Atlanta and Nashville markets, appear to have abated without any persisting effect on wages. This time of the year we, like everyone else, have been watching retail activity. For our District, retail sales have been quite good compared to last year and to expectations, especially for high-end goods like jewelry and home furnishings. That pattern has been pretty even across our District. Of course, auto sales have been noticeably weak, as others have indicated for other parts of the country. I might mention that commercial construction in the Southeast is also quite strong; that construction activity is concentrated in the retail sector. While we are seeing some speculative building of retail space, mostly in Atlanta and Miami, that is not yet at a worrisome level. We also are seeing expansion of office and industrial building, but most of that is on a build-to-suit basis. We see very little speculative building in the office market. As one might expect, Olympic-related building and public projects are adding measurably to activity in both Atlanta and surrounding cities that are getting some draw from the Olympics. Overall, the Sixth District is expanding smartly, although activity has slowed noticeably from this time last year. Still, it remains hard to find problems that are widespread or worsening in either economic activity or in pricing practices.

As far as the national outlook is concerned, the Atlanta forecast on the surface is remarkably similar to the Greenbook's: It includes moderate growth in consumer spending, strong but decelerating business fixed investment, little net contribution that we can see in either direction from net exports, and fairly stable inflation near the 3 percent level. Neither forecast sees serious imbalances. Nevertheless, there are differences in interpretation between our forecast and the Greenbook that have implications for our policy discussion. I will say more about that during the policy go-around. We interpret the relatively benign inflation environment as being in large measure the outcome of the last fifteen years of tough inflation policy. The Greenbook does not seem as confident on that change. But I would also underscore the point that Gary Stern made toward the end of his comments about some of the fundamental changes that have taken place and the reasons that one can be optimistic about the inflation outlook. We do not see the current forecast as a rigid limit on potential growth. In our view, moderate additional growth would likely have no effective inflation cost. In that way, our outlook is somewhat different from the Greenbook and somewhat different from the other comments that have been made around the table. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, it does seem that fourth-quarter growth is somewhat slower than the torrid pace of the third quarter, and that slowing may be in response to that torrid pace. But I continue to be quite optimistic that this slowing is not very likely to be indicative of an undue weakness beginning to set in. I certainly concur with the thrust of Mike Prell's briefing earlier. I think there are some important trends that are going to have an impact in the near term and a little further out in the future stemming from the remarkable decline that we have had in long-term interest rates over the last year. We still seem to be able to create jobs in this country at a rate of roughly 100,000 per month, and the unemployment rate has stayed steady at 5-1/2 percent. Credit availability still seems to be quite ample. Debt formation is going forward a bit more slowly than the very rapid pace of a few quarters ago, but that is welcome. Retail sales are certainly unexciting; the anecdotal evidence about Christmas sales is not strong, but the most recent monthly data that we have, for November, were really rather good. So, that sector of the economy may be all right, and I think with the lower interest rates, housing is going to be all right and probably autos as well. Consumer sentiment continues to be strong, a bit off its highs perhaps but still strong. So, these developments and others leave me pretty comfortable with the Greenbook forecast, which essentially showed no change from November. I liked it then and I like it now. Basically, it calls for growth near potential as the highest probability.

We have to ponder what might change this outlook. As far as an upside breakout goes, it is difficult for me to see where that is liable to come from in the foreseeable future. I would think that an upside breakout would have a fairly low probability. There is always the possibility of shocks, and if we get one of those, we will have to deal with it. But it would seem to me that if one wants to focus on a concern, we might see in the further reaches of the forecast period a general exhaustion at the margin of growth-creating demand, maybe a weakening of investment. I don't see that as a very high probability in the next several quarters. But further out in the forecast period, I think that concern grows because we do have a very mature expansion on our hands.

On the inflation front, I think everyone has remarked, and everyone realizes, that inflation continues to be remarkably well contained. I am particularly impressed with the way that unit labor costs continue to behave. Productivity is still growing very nicely, and the ECI is flat. In the inflation area, the foreign outlook certainly appears benign, and commodities generally have behaved well recently. In sum, I just don't see strong pressures on policy at this time, one way or the other. This leaves us with the rather rare luxury of having a bit of rather low-risk discretionary room to maneuver. I think the question for the next half of the meeting is going to be how we intend to use that.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Thank you, Mr. Chairman. Although we have obtained a significant slug of new data on the economy since our last meeting, my view concerning the outlook has changed very little. I continue to think that the inflation outlook is favorable, that growth is likely to proceed at a moderate pace over the next year, and that under current monetary policy, there will be a bias toward below-trend growth over the longer term. With respect to inflation, I have been particularly impressed by the decline in inflationary expectations, which Bob Parry mentioned. Both long- and short-term inflationary expectations have fallen about 1/2 percentage point since the second quarter of 1995. Direct measures of inflationary expectations suggest, I think, a dwindling fear of an inflation breakout on the part of both households and forecasters, and that is a change in perception that is well warranted. We should remember that such expectations do have at least some direct impact on workers' demands for wage increases and the willingness of firms to grant them at any given level of labor market slack. So, reduced inflationary expectations make a direct contribution to an improved inflation outlook. As Bob also mentioned, the decline in inflationary expectations means that real interest rates, both long- and short-term, have not declined as much as nominal interest rates. Now, I have no quarrel with the short-term outlook in the Greenbook, although I do think the jury remains out on whether or not inventory adjustment is going to proceed along the very benign path that is projected in the Greenbook. But really my most important concern has to do with the longer-term outlook, not for 1996 but into 1997 and beyond. I think that should be the focus of our deliberations since that is when the monetary policy changes we undertake now will really take hold, given the long lags in policy. My reasoning here is similar to that offered by Larry Meyer in his latest forecast. According to his characterization, the outlook is for what he calls a soft landing with bias. After a period of near-trend growth in 1996, he foresees a bias toward below-trend growth thereafter with rising unemployment, assuming that the real federal funds rate is kept at its current level. Similarly, our own MPS model contains such a bias toward below-trend growth under the Greenbook fed funds assumption, although it does project an even stronger 1996 than the Greenbook due to the lagged but temporary influence of wealth effects from the stock market.

I thought I might enumerate some of my reasons for expecting this bias toward below-trend growth, and I will just quickly mention seven factors that are operative in my view. The first is that lower long-term rates have been boosting residential construction with a lag, and I would expect, as does the Greenbook, that that effect ultimately will peter out. Second, we are finally seeing a cessation of the at least year-long trend toward easier credit terms, and that means that one source of stimulus that has been working as an offset to monetary policy over the last year will stop imparting further impetus to aggregate demand. Now, we can dispute whether and how much stock prices matter to consumption, but if higher stock prices are contributing and will continue to contribute in 1996 to strong consumption growth, eventually this influence is going to subside. I think it will be gone by the end of 1996 even assuming there is no major market correction. Fourth, pent-up demand for consumer durables is presumably spent, and it seems to me that rising delinquencies on consumer debt coupled with higher debt service ratios suggest at a minimum less robust consumption growth going forward. Fifth, the growth in business fixed investment seems likely to wane through accelerator effects. Sixth, the lagged effects of the depreciation of the dollar, which should stimulate exports in 1996, will be petering out in 1997 and thereafter under the Greenbook assumption of a stable dollar. Finally, seventh, I would mention that fiscal drag will, of course, be at work throughout and beyond the forecast horizon.

So, it becomes hard for me to see exactly what is going to keep the economy growing at trend over the longer haul. In addition, if consumption spending, in contrast to the Greenbook assumption, is currently being buoyed by the strong performance of the stock market, then any significant stock market correction imparts some downside risk to the forecast. There is consistent empirical evidence in favor of the MPS model assumption of a marginal propensity to consume of 4 or 5 percent out of added wealth. If we take that seriously--obviously we can dispute that--it makes quite a difference. In particular, a 10 percent correction of the stock market would add a half percentage point to the unemployment rate after 6 to 8 quarters. So, clearly, the view that policy is restrictive at this stage involves a difficult and tricky judgment call. I think type I and type II errors are both possible. The Greenbook does offer a very coherent defense of the opposing view, and I think Mike defended that view vigorously. Fortunately for us, monetary policy is a flexible instrument; it can be adjusted in either direction so that any mistakes we might make are reversible.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. Thank you, Mr. Chairman. The economy has been considerably stronger than we might have expected, with growth probably exceeding 5 percent for the third quarter and higher than 3 percent, or at least in the vicinity of 3 percent, for the year 1995. The question for us is how much momentum we can expect going forward. There are some sources of strength to the economy. One area is the labor market. At 5.6 percent unemployment, people are working. They may not be working at the jobs they want. This implies that they may be willing to move, which suggests in turn more flexibility in the labor force than is implied by a 5.6 percent unemployment rate. I think the proof of this assertion is the fact that wage rates have not consistently been under pressure. We have heard a lot of anecdotal stories about labor shortages, but that has not been widespread nor has it crept into the statistics.

With respect to consumer spending, we clearly are getting some mixed signals in both the published data and in the anecdotal reports. We probably have, as Janet Yellen mentioned, worked through the pent-up demand for durables. Consumers appear to be very price conscious and cautious; consumer debt is probably reinforcing this caution. It is pretty difficult to assess the fourth-quarter retail situation. People are probably waiting until that last store markdown, or perhaps they are hitting the discount stores or the catalogs. But as long as people are working, I don't think there is any reason to assume that they will stop spending in any big way. I think it is fair to say that growth in consumer spending is likely to approximate the pace of income growth. So, the upside surprises in this sector of the economy are unlikely.

The housing side has been disappointing recently, but I don't see any reason why it should not pick up a bit, or at least not decline, given the affordability statistics and also the availability of reasonably low mortgage rates. On the business investment side, the fundamentals are reasonably strong for continued investment, though probably not at the strong pace that we saw in 1994 and early 1995. Profits and cash flows are holding up and the cost of capital is low. The markets, I think, are fairly supportive of moderate economic growth. The stock market is strong, generally supported by corporate earnings. I guess I am not quite as pessimistic as Bill McDonough about the stock market being massively overvalued. In the debt market, we have seen the emergence of a flatter yield curve. It has not yet turned negative, but it definitely has flattened out. At the long-term end, the decline in inflation expectations has some obvious benefits for lowering financing costs and improving refinancing opportunities. In the inflation area, we have seen more progress than we probably have a right to have expected. In short, there are no obvious bottlenecks or major imbalances in the economy. This is not to say that there aren't any risks to the economy, and there may be some adjustments forthcoming. The manufacturing sector, as has been reported around the table today, is pretty uneven. We may still have to work off some inventories.

The international demand side, I think, is a bit more risky. Certainly, the United States is in a better competitive situation than has been the case historically. But the question is: Will the international demand be there? The economic outlook for Europe has weakened; the Mexican economy may be bottoming out, but there are still significant risks; and it is questionable whether Japan has fully faced up to some of its difficulties.

With respect to the fiscal negotiations, with a good part of the government still closed down, this remains a concern. I would argue, however, that we know more now than we did at our meetings in September and November. With respect to the debt ceiling, we clearly have bought some time. Rather, I should say that Secretary Rubin has bought some time, and there is a commitment to avoid default. Government operations are going to reopen one way or another. I think politicians will not be able to resist the political backlash from the inability of the public to get services. We also have the specter of public employees getting a paid holiday. In a week or so, they will be eligible to file for unemployment benefits. There also will be complaints about the unfairness of unpaid layoffs for the holidays. Under either a continuing resolution or an agreement, which may not come until next year, there will be some fiscal drag, but not that much in the near term. It seems to me that the point for us, with respect to the fiscal situation is that the areas of discussion are narrowing. From our perspective, I think there is probably more confidence that a deal eventually will be struck, but there will be some federal drag on the economy.

In sum, I think the case continues for moderate growth, but I think there clearly will be some unevenness in that growth.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Thank you, Mr. Chairman. The only new piece of information of an optimistic type coming from our District was a report that recent shipments and backlogged orders for candlewicks were at record levels. [Laughter] I have not seen that indicator before, and I don't know if staff can attest to its reliability! One of the chief executives of a major company said to me that if we want to avoid a pickup in inflation, we need to ease monetary policy very substantially. I asked him to explain that. He said that recently his sales were off, orders for the first half of next year did not look very good, earnings were under pressure, and if things did not pick up, he was going to have to raise his prices. This is one of those occasions where I regret that this job prevents me from shorting his stock!

Western Pennsylvania resembles what Ed Boehne was describing for his District; it had been relatively soft throughout this period of robust expansion in the rest of the Cleveland District. But the other parts of the District including all of Ohio and especially central and western Kentucky that had been so strong have distinctly cooled in every respect, especially in motor vehicles, metals-related industries, residential and nonresidential construction, and on down the list. One director reported that pre-Christmas retail sales were very disappointing. A banker responded that they have been disappointing for the last forty years, and so that exchange didn't seem to add too much to our knowledge.

Two years ago at this time, we were contemplating head winds and the extent to which those head winds had diminished sufficiently so that we could start to raise the funds rate and get our foot off the gas pedal so to speak. Everyone inside and outside the System agreed that a 3 percent funds rate was simply too low at that time. A year ago at this time, we were observing tail winds. We were busily reefing the main sails to keep them from gaining too much momentum and trying to figure out how high it was going to be necessary to take the funds rate in order to prevent an acceleration of inflation. As it turns out with the advantage of hindsight, 6 percent was sufficient. Whether it was more than sufficient is debatable, but it was certainly adequate for this round. That says that 3 percent was too low and that 6 percent was at least sufficiently high, so we have the range bounded. We are talking about where the rate should be in between. Currently, at least from my District, it feels very much like the tail winds are diminishing. Two years ago, our anecdotal information put us ahead of the Commerce Department or even the BLS statistics about the need to start raising the funds rate. A year ago, our own anecdotal information or observations around the System led us to believe that we were reaching the topping-out point well before most forecasters were saying that we were going to stop raising the funds rate. Now the information from the majority of us around the table tells me that we are a bit ahead of the numbers in hand and that de facto policy has become more restrictive. I think that a 5-3/4 percent funds rate is now more restrictive than 6 percent was last February because of what has happened in between. The anecdotal information says to me that the equilibrium real rate has moved down, and what we do about the nominal rate has become a question of timing.

Let me make a normative comment or two about the Greenbook forecast. I like the real growth rate and the employment and unemployment numbers projected through 1997. If they turn out to be close to the mark, I would be very happy with that result. As some others have commented, I don't like the inflation numbers, especially the CPI numbers. What is puzzling is that if we were targeting nominal GDP, I think the numbers in the Greenbook would look pretty acceptable to everybody, with growth in nominal GDP getting down to a rate of about 4 percent in the second half of 1997. If nominal GDP is cruising along at about 4 percent, that ought to get us pretty close to where we think we want to be in terms of the purchasing power of the dollar. But the CPI doesn't show that kind of progress in the Greenbook projection, and I don't think the Greenbook is internally consistent on the policy assumption and the numbers that are being produced there. I simply don't believe that a nominal 5-3/4 percent funds rate out well into 1997 is consistent with the kind of pattern that is being shown for nominal GDP. Like Al Broaddus or Tom Melzer, I would like to have a forecast that would move us in the direction of price stability. Current policy at best is going to be influencing inflation in 1997 and beyond. I would like very much to have a forecast that shows inflation at about a 2 percent rate at the end of 1997. The reason we can't ask the staff to produce such a forecast is that it requires us to raise unemployment or contract output or hold it below potential. Since I don't want to do that, I can't ask the staff to produce a forecast of inflation that I can translate into an objective. We have to sit and wait and hope that we get lucky and find that potential output turns out be higher than we thought, and we get positive productivity surprises that produce lower inflation. That would be true even if we were at 10 percent inflation. In this framework, once we get to full employment and potential output, it doesn't matter what the inflation rate is. We are stuck with it forever until we produce a recession or raise the unemployment rate. I don't want to do that. I don't know how to end this process and establish an objective of lowering the 3 percent CPI to 2 percent or 1 percent or whatever number we said we were going to accept. I am uncomfortable with this forecast because I believe fundamentally that if inflation rates are not moving down, they are moving up. Yet, we have an inflation rate that continues unchanged forever out there, and I find that difficult to accept.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. I am going to be blissfully brief. As I sat down last night to write some notes for this meeting, I remembered something my basketball coach taught me when I was very young about shooting free throws. He used to say: the basket is the same, the ball is the same, why can't you be the same? Here we are in December, and I am thinking back to November. The Greenbook is the same, the economy looks the same, and I feel the same way about the economy. I want to elaborate on that just a little. I want to make one point: As has been noted by several people, the Greenbook, except for a few trivial details, is essentially the same Greenbook we had five weeks ago. The economy, I would say, looks the same as it did then, only more so. In broad outline, we were looking then at an economy that had shown a surprisingly strong third quarter; now the third quarter looks surprisingly stronger. The economy was showing signals of weakening in the fourth quarter, which I think have continued to come in. In addition, we had a big question mark about the budget, and now we have a huge question mark about the budget. In consequence, I essentially feel the same way about the economy as I did five weeks ago, only more so.

The preponderance of risks, as I said last time, looks to me to be on the down side. I am not going to go into the details of why since you have already heard that around the table. I think the biggest new risk in the last five weeks is the additional inventory pileup that seems to have occurred since then. I am a bit more worried about that than I was five weeks ago. Secondly, it certainly looks, as it did five weeks ago, that the economy can grow at trend with about 5.6 percent unemployment and about 3 percent inflation for a while, maybe a long while. But private forecasts that have this scenario, and many do, are almost all predicated on an easing of Fed policy; the Greenbook forecast is not predicated on an easing of Fed policy. I might add that the market rallies that are propelling or expected to propel the economy forward are also predicated on a Fed easing. We saw a little of that come out of the markets yesterday. The part of the argument that said, "the budget will be fixed and therefore the Fed will ease" took a small hit yesterday in the market. I think we got a little microcosm of what might happen if in fact we don't ease. Thirdly, the real fed funds rate looks restrictive to me as it did a month or so ago. My notes here say exactly what Jerry Jordan said: It seems to me that the funds rate is more restrictive now than it was in February when we were actively stepping on the brake. It is hard for me to understand why in December we would want to be stepping on the brake more firmly than we were in February. I can't understand that at all, nor could I five weeks ago.

The only thing that I have to say today that is not a repeat of what I said five weeks ago is a comment about wage pressures. This has been mentioned by several people around the table. We ought to recall that labor lately has been taking it on the chin quite badly, despite apparently tight labor markets. Real wages are going nowhere, and profit margins are going everywhere. One manifestation of this is that the gains from diminished health care costs are being pocketed by firms in the form of profits, not by labor in the form of wages, which is what a conventional theory of incidence would have led us to expect. I raise this point for those who have a fear of wage pressures. I raise it to suggest that we ought to expect some reversal of this in the natural order of things. There ought to be a period of time when wages grow faster than prices just as there has been a period of time when prices grew faster than wages. As this aberration straightens itself out, and the wage-price relationship goes back to what most of us think is consistent with the normal long-run theory of incidence, there does not necessarily have to be an acceleration of prices. It would simply be the relative wage-price ratio snapping back toward what it was a few years ago. That is all I have to say.

CHAIRMAN GREENSPAN. Let's break for coffee.

[Coffee break]

MR. KOHN. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Don?

MR. JORDAN. Don, ignoring lags and transition problems, in a future steady state environment with nominal spending expanding at a 3 to 4 percent rate, output growing at potential, and the economy perceived to be at full employment with price stability, in what ball park would you guess the nominal fed funds rate would fall?

MR. KOHN. I think under those circumstances it would be below where it is now. You are talking about 2 percentage points less inflation than now, 1 percent instead of 3 percent. So, as a first approximation, I would shave 2 percentage points off the nominal funds rate just to keep the real funds rate from rising, since inflation is that much lower. As to what real funds rate is consistent with the economy growing at its potential, which is the other part of your question, I think that is really difficult to say. We have discussed that a couple of times over the last six months. You can see that so-called equilibrium funds rate bouncing around quite a bit in any model simulation or any look at how the real funds rate has behaved over time relative to how the economy has behaved. We ran for much of the 1980s, certainly the middle part of the 1980s, with nominal interest rates pretty consistently above the growth of nominal GDP, though not every year. That pattern was consistent with a fairly vigorously growing economy and steady inflation in the 4 to 5 percent range. Now, that was associated with some fiscal stimulus, so I think we had a higher equilibrium funds rate in that period. Most people think that the equilibrium funds rate is probably down relative to what it might have been in the 1980s, but how far down is very hard to say. The structure of the economy and the structure of financial markets have changed markedly since the 1950s and the 1960s. We don't have Reg Q, for example, to cut off spending when market rates get high. It is quite conceivable to me that the long-run equilibrium real interest rate at steady inflation right now would be higher than it was back then. One could perhaps run with nominal interest rates above nominal GDP for awhile; it would depend on the stance of fiscal policy and the other things that affect the economy. I don't think there is a simple mapping of nominal GDP growth and nominal interest rates, although there is a relationship.

MR. JORDAN. Maybe you answered it with this matrix and your other remarks. It is all very interesting. Maybe I didn't understand what you were saying; I am trying to clarify it. Starting from where we are today--the perception of full employment, an economy operating at capacity, the current funds rate, and the inherited inflation rate as it is reported--what is the transition mechanism for getting the funds rate from where it is to where it would be in a steady state environment without creating slack?

MR. KOHN. What is the transition mechanism for getting inflation down?

MR. JORDAN. What are the conditions under which you would say, without economic slack occurring or being forecast, that we move from the 5-3/4 percent funds rate to that steady state funds rate?

MR. KOHN. I think there are two points. One would be that slack occurs that you had not anticipated, perhaps because potential is higher than you thought or there is a shortfall in demand you had not anticipated. When that occurs, you are going to have a little slack in the economy. You react to get rid of that slack, but meanwhile you are running below potential and that would put downward pressure on inflation. I think the opportunistic strategy here is to take that downward pressure. Don't try to push the economy back above potential to make up for the output that you have lost in the meantime. So that's one source. Another source would be that inflation expectations have come down--something that, as I hear it, some of the people around the table think has happened recently. If inflation expectations have come down, that would put some downward pressure on the inflation process. As Governor Yellen mentioned in her remarks, if they truly have come down and particularly if they are in the process of declining further, that would enable you to hold the economy at potential and have inflation come down further. Now, whether you could logically count on much of this sort of immaculate conception of a decline in inflation expectations--if you'll pardon the expression--while holding the economy at potential is difficult to say. But that would be the other way it could happen. You are right, President Jordan, in suggesting that the economy is constantly being hit by shocks, and it is not a question of deliberately putting slack in the economy to bring inflation down. It is a question of taking those shocks, whether they are on inflation expectations, demand, supply, or whatnot, and using them to bring inflation down. Over time, if you react asymmetrically to shocks, strongly to upward shocks and less strongly to downward shocks, the inflation rate will work its way lower.

CHAIRMAN GREENSPAN. Vice Chairman McDonough.

VICE CHAIRMAN MCDONOUGH. Don, without benefit of your very good two pages, which would have saved me a good deal of work last night, I spoke in favor of the opportunistic approach this morning. Since we don't agree with the Greenbook, I guess our model would fit in your matrix where you have disinflation pressures and would then move down to the box that indicates a permanent drop in inflation expectations and ergo a reduction in nominal rates that leaves real rates unchanged. My question is, is it safe to assume that opportunistic versus deliberate are two different policies without implying that one is necessarily more virtuous than the other?

MR. KOHN. I am not sitting in moral judgment here. I think it is a question of your ultimate goal and the gains you think you are getting from your ultimate goal--that is, price stability--and the losses you are willing to incur to get there. If you really believe that 1 percent inflation would produce over time a lot higher productivity, a lot higher output, a lot more benefit to the economy than 3 percent inflation, then perhaps deliberately giving up short-run output gains would be warranted to allow you to get to 1 percent inflation faster. If you are somewhat uncertain about the net gains of going from 3 percent to 1 percent inflation, it seems to me that you are potentially maximizing society's welfare by going there slowly and taking advantage of the opportunities of getting there without necessarily punishing the body economic.

VICE CHAIRMAN MCDONOUGH. Just a comment: I think you could be equally convinced of the benefits of getting to the low inflation rate but just decide that the price of getting there very quickly is excessive. There would be no difference in the goal, in my view, only in the speed at which you are willing to get there and the cost to society that you are willing to incur.

MR. KOHN. That's a good point. A lot of models put in utility functions that penalize large misses from output more than small misses from output. On the other hand, if you think that the world is pretty linear and symmetric, in the end it's not so clear. I think it's an open question if you really want to get there, whether going there slowly results in higher utility for society than going there quickly, assuming there is a lot to be gained when you get there. You are giving up years at price stability by going there slowly.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Don, I just want to make sure that I understand the paradigm completely, not using the current policy issues so much as a bit of recent history. I would be interested to know, within the context of this, how you would interpret our initial tightening back in 1994. I would have thought of that intuitively as opportunistic. As I recall, the inflation rate was not rising significantly. What was happening was that bond rates were backing up. Some of us at least had a sense that that indicated a rise in inflation expectations, and of course there was evidence of strength in the real economy.

MR. KOHN. I would interpret it under 3.b.i. in my outline, that is, leaning hard against potential increases in inflation. As you saw inflation developing, you moved vigorously against it. So, I think it's perfectly consistent with the opportunistic strategy. Some of this may be a bit endogenous since the people who practice that policy are defining the opportunistic strategy. But as I defined it--we are listening to you folks--I think that is perfectly consistent with an opportunistic strategy: lean hard against shocks in one direction, take a more measured approach to shocks in another direction.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Thank you, Mr. Chairman. Don, I would like to focus on the middle column of your bottom chart. Would you speak specifically as to what this column means to you in the current situation? When I look at the Philadelphia survey of inflationary expectations, it seems to me that the first thing to make assumptions about is how much of the drop is permanent. If I wanted to keep the real rate constant and thought it was all permanent, I would probably need to reduce the rate by 50 basis points. If I wanted to take more of a Brainard approach and not go the full distance, the rate reduction might be a quarter. What does it mean to you?

MR. KOHN. I think that from the perspective of the real world situation of the last six months, it is a little fuzzier than it seems in these boxes. For one thing, I think the Committee anticipated a drop in inflation and inflation expectations when it cut the funds rate in July. That's why you did it. Inflation had come up, and you could see that that rise wasn't permanent. It was going to come down, and you expected it to come down. If you had not expected it to come down, you would not have cut the funds rate at that time. What we really need to know is what you thought inflation would be when you cut that rate. Judging from the central tendencies in the Humphrey-Hawkins report, you thought inflation would be about a quarter point higher than it seems to be turning out for 1995. Whether that's what the market expected and how your expectations compared to that is not clear. But you have had a favorable inflation surprise relative to your own expectations as given in the Humphrey-Hawkins report. I just don't think it's a full half point because some of that is the market catching up with what FOMC members expected to happen. The other point, of course, is that leaving real rates unchanged assumes that the intended real rate was the right real rate. That's the other judgment you have to make. In fact, you have had a lot more growth in the second half of the year than you anticipated in the Humphrey-Hawkins report.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Don, I am a little surprised that you recommend responding to a supply shock or a demand shock in the same way in your matrix. I would have expected different signs. The easiest way for me to think about it is to suppose the reverse happens if you have a negative supply shock, say an oil embargo, versus a positive demand shock. If you had a positive demand shock, I think the right prescription would be to raise nominal real rates because you would want to offset the demand. If you had an oil embargo, I would not recommend raising nominal and real rates. In other words, I think there is a difference.

MR. KOHN. I am not sure I followed you entirely, but there are a couple of points. Part of this is the asymmetry of the opportunistic strategy. Several types of supply shocks are possible, and I think that is a complication as well. If you are looking at the middle panel here with a positive supply shock, cutting nominal rates enough to keep real rates unchanged is what keeps you at potential, since under the opportunistic strategy the Committee is not seeking to drive the economy below potential or have it above potential. On the other side, if you have a negative kind of supply shock, you might want to drive real rates higher to lean against that supply shock. That was the example in 3.b.i. of my outline where policy attempts to hold the line against increases in inflation by accepting output losses in the event of adverse supply developments. So, it seems to me that if you had an adverse supply shock, you would want to raise nominal rates perhaps by even more than the increase in inflation expectations in order to raise real rates. This presumes that you thought the supply shock was feeding through to inflation expectations, and you wanted to respond so that you wouldn't end up with a higher inflation rate at the end of the day than when you started.

MR. LINDSEY. I will talk to you another time.

MR. KOHN. Okay.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. The answer to that question obviously depends, among other things, on whether you think the shock is temporary or permanent. That is extremely important. Larry is looking at a temporary shock, and I believe Don is thinking about one that is permanent. That is not the only variable but it is critical.

I want to make a couple of points. First, I think this is a very good discussion to have. I only wish I knew we were going to have it, because I began thinking about this subject only when you started talking. I have thought about it before, but not within the last month. So, I hope this won't be the last of it for this Committee because I don't think I am the only one who didn't know that this subject would be on the agenda.

I have a couple of substantive points. Among the considerations in choosing between these two strategies are the following, though these are not the only considerations. How important do you think losses of output are? That is very important. And--Don, you touched on this obliquely--what are the relative social costs of the <u>level</u> of inflation, especially at low levels, and <u>changes</u> in the inflation rate? This is critical, I believe. Then there are technical considerations, and if I had known about this topic last night, I would have pulled out the work that the staff did on it and could be eloquent on the subject. The choice does hinge sensitively on the marginal costs, around the target inflation rate, of small deviations in output and inflation. Are these costs linear or quadratic; how is the loss function curved; and so on. I won't try to get that right now, because if I try, I will probably get it wrong. That is one set of comments.

The second set of comments: You characterized the opportunistic strategy, which like Bill McDonough I favor, as waiting for the unanticipated to happen. In some sense that is right, except that we know it will happen. It is not that we think we will go for the next thirty years without a recession. We don't know when the recession will come, but we know it will come. We also know that when it comes, even if we are being opportunistic the way you describe it here, we will not react fast enough to stop it in its tracks. So, there will be a recession and there will be a period of slack. That is what a lot of us mean when we say that we are "one recession away from price stability." It takes a very nimble central bank to move fast enough to avoid the slack that drags inflation down a point or two points when a recession occurs. It will happen with a probability of one. So, it is not unanticipated in some long-run sense; it is unanticipated only as to the timing. That's crucial because, if it was literally unanticipated, you might never get to price stability by the opportunistic strategy.

I also have a couple of quarrels with the way I think you portrayed the strategy. Although in your discussion with Jerry Jordan it went the other way, I thought you said you were looking back at inflation performance rather than looking forward at inflationary expectations. I would have thought you would have wanted to do the latter--to look forward at inflationary expectations, not backward at the actual performance. Secondly, I think your matrix, as I think of it, is not quite right in terms of changes versus levels. That is, "tighten" or "tight" and "easier" or "easy," so to speak, are two different things. I would have thought the question was whether you wanted to be "tight" or "easy." I can imagine easing from a very tight position, and I can imagine tightening from an easy position. Either could still leave policy on the same side of neutral. I think the critical distinction here is which side of neutral are we on, and which do we wish to be on. In that regard, we cannot avoid taking a stand, to use a well worn phrase, even though we know we don't know for certain what the equilibrium real interest rate is. That is our choice. Do we want to be on the north side or the south side of the equilibrium real rate? Once we put ourselves there, the rest basically will take care of itself if we are right, but with very long lags and uncertain timing. If we are close to equilibrium, it is going to be uncertain as to whether we are on the right side because, as I said, we don't actually know the equilibrium real rate. But the fact that we can't know this number with certainty doesn't avoid the need to estimate it. It is the same sort of uncertainty that we face all the time. We don't know what the economy is going to do in the next six months, but we have all these people here to estimate what it is going to do in that period.

My last remark will tie that to the current situation. I think that right now we are in a deliberate strategy posture, since I believe, as many but not all of those around the table believe, that we are on the north side of the equilibrium real funds rate. A version of the deliberate strategy is to hold the funds rate unchanged and let the economy do what it will, which is to create slack and bring the inflation rate down. Whereas the opportunistic strategy, as Bill characterized it, would ease now and presumably try to bring the real fed funds rate to roughly what you think the equilibrium rate is.

MR. KOHN. I thought in effect that's what I had in the lower row here. One way to think about this--the way I thought about it as I was writing it--was that the upper row had the Greenbook assumption and the equilibrium real rate approximately where it is now. The lower row had some words like this--

MR. BLINDER. I would have labeled the top row as having a real equilibrium short rate of 2.75 percent and the bottom row as having a rate of less than 2.75 percent.

MR. KOHN. That's exactly what I had in mind. I was not taking a stand since I had two alternatives here, but I think those notions of the real rate were behind these alternatives. I want to go to one other comment that you made because I think it raises an interesting issue that I tried to point out as we were going through this. The question of why you take disinflation but you don't seek disinflation does rest on these points about the utility of less inflation and how much is gained or lost by different actions relating to the level of inflation versus a change in inflation or the level of output versus movement of output away from potential. I think these are the sorts of things we need to think more about to write down a model in which we really can be confident. I agree that my colleagues have written down an interesting model that produces this result, but it is that issue that I think is the most difficult to confront when you are talking about the opportunistic strategy. I think we talked about this at the September meeting. If the Mack bill ever becomes law, the Committee will need to confront these issues: Why are you doing this deliberately? Why are you not doing this deliberately? Why do you have the opportunistic approach? Is it worth going to price stability? Why not get there? This question of justifying this opportunistic strategy in a fundamental underlying sense of society's utility will, I think, be very much on the table if we have to confront that particular bill.

MR. BLINDER. I agree with that.

CHAIRMAN GREENSPAN. Any further questions for Don? If not, let me start off. I will take a little more time than usual because despite the short-term budget turmoil and all sorts of churning in the economy, in concert with Don's endeavor to sketch out longer-term policy issues, I want to raise a broad hypothesis about where the economy is going over the longer term and what the underlying forces are. While I have not seen Don's set of boxes before, I am sure you are going to fit me in one box after another as I go through this, but I hope you won't try to do it too readily! [Laughter]

You may recall that earlier this year I raised the issue of the extraordinary impact of accelerating technologies, largely silicon-based technologies, on the turnover of capital stock, the fairly dramatic decline in the average age of the stock, and the creation as a consequence of a high degree of insecurity for those individuals in the labor markets who have to deal with continually changing technological apparatus. One example that I think brings this development close to home, even though it is an unrealistic example, is how secretaries would feel if the location of the keys on their typewriters were changed every two years. We are in effect doing that to the overall workforce.

As I indicated in my remarks two or three meetings ago, we are getting as a consequence of this a very significant increase in the sense of job insecurity and indeed the trade-off between job insecurity and wage increases. To my mind, this increasingly explains why wage patterns have been as restrained as they have been. One extraordinary piece of recent evidence is an unprecedented number of labor contracts with five- or six-year maturities. We never had a labor contract of more than three years' duration in the last 30 to 40 years, though I am certain that somebody can come up with an example of some quirk somewhere along the line. As far back as I can recall, the maturity distribution of labor contracts in the BLS data was always cut off at three years. The underlying technology changes that support this hypothesis really appear only once every century, or 50 years, or something like that as best I can judge, and many of you have been giving various examples that support this hypothesis, Gary Stern obviously being one.

I think the accelerated capital turnover and the advancing technology are having, in addition to the labor market effect, a fairly pronounced impact on costs for different reasons. Basically, the downsizing of products as a consequence of computer chip technologies has created, as you are all aware, a significant decline in implicit transportation costs. We are producing very small products that are cheaper to move. They also are cheaper to move across borders, and so we see them spreading around the world. More importantly--and this is really a relatively recent phenomenon--is the dramatic effect of telecommunications technology in reducing the cost of communications. A while back, The Economist had an article that was called, I think, "The Death of Distance." They were pointing out, as one readily observes, that we are gaining the ability to make telephone calls between Washington and London, for example, at the same cost as between Washington and Baltimore. The reason is that increasingly as fiber-optic-related technologies and satellite communications evolve, the cost of adding 200 or 1,000 miles doesn't matter when you are going 22,000 miles up and 22,000 miles down. That is why the Internet charges essentially flat fees for all subscribers, and connections can be made anywhere. The reason is that distance doesn't change the underlying cost.

What this has done is to create a major force for increasing labor specialization because it broadens the scope of what an individual or company can get involved in. We are raising the old issues of comparative advantage and the division of labor out of the old Economics I textbooks. In effect, as the downsized products have spread and the cost of communications has fallen, the globe has become increasingly smaller. In the 1850s, a farm somewhere in the Midwest would have been a self-sufficient, fairly low productivity operation because there was no comparative advantage. What we are now seeing is a tremendous move toward the proliferation of outsourcing, not only in the immediate area but ever increasingly around the globe. What one would expect to see as this occurs--and indeed it is happening--is the combination of rising capital efficiency and falling nominal unit labor costs. In fact, that is happening by every measure we can look at.

One may readily argue that this process has been going on in one way or another since the beginning of the Industrial Revolution, but I think we are now seeing an acceleration of the process largely as a consequence of the type of technological change that is occurring. I have been looking at business cycles since the late 1940s and have been aware of the various technological changes; there was just nothing like this earlier. This is a new phenomenon, and it raises interesting questions as to whether in fact there is something more profoundly important going on in the longer run. We usually dismiss that sort of development on the grounds that its effect on the short run is nominal. I have a suspicion that in this period, unlike previous periods, we will find that the long-run, deep-seated forces are not so gradual as to be readily dismissed in any short-term economic evaluation. I suspect that the evidence is increasingly emerging that there is something different going on, which we have not looked at for awhile.

One would certainly assume that we would see this in the productivity data, but it is difficult to find it there. In my judgment there are several reasons, the most important of which is that the data are lousy. I think we have not correctly defined how to capture the value added in various industries, as I believe I have pointed out previously. Looking at market values, we are not capitalizing various types of activities properly. In the past, we looked at capital expenditures only as spending on a blast furnace or a steel rolling mill. Now, improvement in the value of a firm is influenced by such factors as how much in-house training they have and what type. That creates economic value in the stock-market sense, and we are not measuring it properly.

Secondly, I suspect that we also may well be looking at the lag that Professor Paul David of Stanford has been talking about. It relates to the question of why computer technology is not creating the productivity that we would expect to observe by looking at individual companies. The reason is largely that the global infrastructure has not yet adjusted. In a similar manner, we had electric motors coming into use in the late part of the 19th century, but they were put into a system whose infrastructure was built on minimizing costs for steam engines. The technology of a steam-engine economy is fundamentally different from that of an electric-motor economy. It wasn't until the construction of horizontal types of factory buildings in the 1920s that our manufacturing firms finally were able to take advantage of the synergies implicit in the electric dynamo and achieve fairly dramatic increases in productivity. This showed up and correlated fairly directly with trends in unit motor use and secondary uses of electric motors, which I thought Professor David did a remarkably thorough job in evaluating.

While the analogies are not exact, there is something extraordinarily obvious as we read through what he is saying and observe what is going on now. Firms are putting tremendous efforts into computer technology. A lot of it is wasted, as inevitably it must be, and we still have not restructured vast parts of the way we do business to fit a fundamentally new technology. It is going to take a long while to do that. It is unclear exactly how that fits into our policy process. But I think it is important to put this point on the table, and I present this as a hypothesis since it is something that we will not be sure is the appropriate assessment of our changing world for probably five to ten years. But the point that Don Kohn has been raising and we have just been discussing is very critical to what we are doing.

Let me suggest to you what the recent short-term evidence appears to be that is consistent with this hypothesis. Ultimately, when we have a hypothesis, the facts either fit it or they don't. The wage pattern that I mentioned is clearly consistent with it. It also has been mentioned here, I think quite importantly, that breaking the back of the inflationary surge last year and early this year was a lot easier in retrospect than it should have been. You may recall that the markets had federal funds rates projected to the moon a year ago. The reason they did is not because they were not thoughtful. The reason is that previous relationships implicitly called for substantial increases in the federal funds rate to restrain and contain the burgeoning inflationary pressures that we were looking at.

As has been mentioned many times, the CPI is currently running under expectations or forecasts. My suspicion is--and this is a benevolent outlook in Don's context--that we are going to find that the inflation rate will continue to come in below expectations. I think this process is not about to come to an immediate end, although I will suggest in a minute why it is not a permanent state of the world that would allow central banks to pack up and go home. I found the charts on long-term inflation expectations in the Greenbook, Part II, really quite startling because they suddenly dip fairly sharply with the emergence of a general awareness that we are in a late stage of a business cycle period that has not created the inflationary problems that previously have occurred in the post-World War II period.

The sharp decline in long-term yields has struck me as quite extraordinary. I know of no one who forecast that with any degree of confidence. Despite the Treasury, we are getting issues of 100-year bonds, and that occurs only infrequently. The last time it happened was in 1993. Before that, I think it was the turn of the century. That in effect is saying that there are people out there who are willing to take low yields for 100 years. The fact that some borrowers are issuing these bonds is terrific. Until you get somebody dumb enough to buy them, that is terrific. But the point is that they are selling, although they may not sell in the future because of the new tax concerns.

Finally, it is very difficult to find typical inflationary forces anywhere in the world. If this phenomenon is correct, it has to be worldwide. What we are observing is 1 to 2 percent inflation in Europe, and none to speak of in some areas where inflation really should be at a high level. What has surprised me most of all very recently is that the CPI inflation rate in Argentina was 1.7 percent for the last 12 months, and that was not per month. Even the outside inflationary processes are being contained. Something different is going on. I don't deny, as has been argued here, that central banks have been a factor in this. I suggest to you that we are probably necessary conditions for this state of affairs to persist. But I would suspect that if we did not have these technological changes going on, our job and that of our counterparts abroad would have been materially more difficult.

I certainly can agree that my hypothesis is the statistical equivalent of a falling NAIRU. That's all fine and good, but merely saying that the NAIRU has fallen, which is what we tend to do, is not very helpful. That's because whenever we miss the inflation forecast, we say the NAIRU fell. We have to understand what it is that is causing this. I am always uncomfortable with a national NAIRU number because I always look at local NAIRUs. I do not think there is the same slope on inflationary expectations across local areas. I am a little dubious of the national number, but I would grant that there is a fairly impressive statistical relationship between inflation and the national NAIRU. What I am saying is that if this hypothesis is correct, we are looking at a significantly different set of inflation pressures in the world economy. I keep mentioning the word "if" because it is a hypothesis. It is one that I have been thinking about for over a year. The evidence continues to come in and suggest that there is something going on here. If it is true, then clearly we can reach price stability with real interest rates lower than where they are now. I do not know where this hypothesis fits in Don's chart, but it is in the most benevolent square.

MR. BLINDER. The positive supply shock square in Don's chart.

CHAIRMAN GREENSPAN. Yes, the positive supply shock square. However, before I go too far, let me repeat what I said when I first raised this issue about worker insecurity and wages. If at a fixed degree of job insecurity there is an associated rise in real wages, then at a higher level of job insecurity we would get the same trend at a lower level of real wages. What I think is happening to us now is that we are going from this higher level of insecurity and tilting down into a lower level. The transition period, by definition, temporarily creates a much slower rate of change, but ultimately we get back to a new level with a rising trend. The same thing occurs when we look at capital efficiency or this type of hypothesis. It is a transitional issue, and it is not one that puts us in a permanent state of noninflation. What we do not know is where the fulcrum of this process is, whether it is out there six months or six years. The Paul David argument would say that it is out there six years. I don't feel that confident about it, but clearly this article, which incidentally was written in 1989, has turned out to be extraordinarily prescient as to what has occurred.

Getting down to the mundane question of where that leaves us for policy today, as a number of you have maintained, falling inflation expectations have increased the real funds rate since July. Indeed, there is a question as to whether in fact the rate is higher now in real terms than it was when the nominal rate was at 6 percent. It is a close call as to whether it is higher, but it is not something that one readily rules out. I know there is a sense of strength implicit in the Greenbook. I have difficulty with it. To me, the economy has more of a feel of driving with the parking brake partially engaged. One gets the sense that the economy is not breaking out as I thought it might last summer. That suggests to me that the upside potential in this economy is limited. I come to the conclusion, which should not come as a surprise, that we rightfully should be moving the funds rate lower.

What are the risks? I am not worried about product price inflation if for no other reason than I think that the longer term is helpful. But I am a little concerned that the behavior of inventories has not been as benevolent as I would have expected. I agree with Mike Prell; I do not think that one can readily see real overhangs except in motor vehicles. But we are not down to the slimmed pace that I felt we might have reached by now, and it is making me a little uncomfortable. So, I am not concerned about moving lower in the context of worrying about reigniting product inflationary forces. I think the probability of that is very low and frankly 25 basis points is not in that regard a big deal. The real danger is that we are at the edge of a bond and stock bubble. Yesterday's market clearly helped, but it is not going to last very long. The sharp runup in stock prices is very heavily determined by the climb in long-term bond prices, but not fully. There has been some not insignificant decline in real equity premiums, and even though we are still well above the dangerous levels of October 1987 prior to the stock market crash, we are in the lower ranges so to speak. It would not take terribly much to drive us through. That is the reason why, if we are perceived to be easing policy, it is conceivable that we could foster further problems in that regard. Fortunately, I think we may be close to at least some temporary peak in stock prices if for no other reason than that markets do not go straight up indefinitely, and the Dow Jones Industrial average has been going literally straight up.

I have no problem with moving down now knowing that, if the economy picks up, we have a quite significant amount of time to move back up again and to tighten to whatever extent we think might be required. I think nonetheless that we have to be a little careful about being too aggressive. I would be uncomfortable with 50 basis points unless I knew for certain that the hypothesis that I have laid out here today were really true. In fact, if somebody guaranteed it to me, I think we could safely go down 100 basis points.

I would go 25 basis points now with no change in the discount rate. It is conceivable that we may have to go lower. I do not think that we have to make that judgment, and indeed it is not a judgment that I think it is appropriate for us to make at this time. The reason that moving down more than 25 basis points would be a big deal is that we would then raise the discount rate question. I think that requires a great deal more confidence that inflation is contained. I would go symmetrical if we move down 25 basis points. I would recommend that the action be accompanied by a statement that emphasized that the reason for the action would largely be the behavior of inflation. For example if we were to do it, I would recommend that the operative paragraph of our press statement say something like: "Inflation has been somewhat more favorable than anticipated since the last easing of monetary policy in July, and this result along with an associated moderation in inflation expectations warrants a modest easing in monetary conditions."

I would eschew two issues in the press release. One, I would not say anything that has to do with the economy because I do not think the economy is what is relevant here. I may not feel as strongly positive about the economic outlook as the Greenbook, but there is no real evidence here of cumulative deterioration. I think this is basically a long-term inflation adjustment process in which we are trying to set the real funds rate at the point where we can move toward price stability in a coherent way. Secondly, I would not like to see the word "budget" mentioned in the release because there has been much too much said about our basically rewarding good budget actions and penalizing bad budget actions. We are not in that business nor can we nor should we be in such a business. Nonstatement of any budget considerations will, I think, speak more loudly than anything we could say. In any event, I have run out of things to discuss, and that is my recommendation at the moment. I call on President Minehan.

MS. MINEHAN. I think you have laid out an extraordinarily intriguing and interesting scenario. When preparing for this meeting and looking at the forces in the economy, our use of a traditional Keynesian framework to evaluate the Greenbook forecast led us to agree with that forecast--the patterns of good solid growth, stable inflation rates, low unemployment and so forth--and we saw the risks to that forecast as being relatively balanced. However, when one begins to think about the changing framework--that is, the NAIRU being lower, using that as convenient terminology, or the economy's potential being higher and perhaps providing a little more room for growth without higher inflation if that new environment has materialized--then it is quite tempting to think of the current level of real interest rates as too high to promote the projected levels of growth. The new framework suggests some additional room to probe on the up side or the down side, however one wants to look at it, and possibly to get more growth out of the economy at given levels of inflation or even declining rates of inflation. I would like to believe that such a new world is here and that there is some evidence, given the reactions of wages and so forth, that says it is here. However, I don't think the evidence is strong enough yet to be really persuasive.

Reflecting on your comments about the potential bubble in the bond and stock markets, Mr. Chairman, it is hard for me to believe that real interest rates are too high. It is also hard for me to think about easing credit in the face of the kinds of financial markets that we have right now. The costs of being wrong, both in terms of the stock and bond market bubbles and in terms of capacity constraints and so on if the world has not changed, clearly are much higher if upside risks are realized as opposed to downside risks.

So my basic inclination would be not to change policy at this meeting, but I can't debate 25 basis points. We talk about having purchased insurance against downside risks in July. My attitude at this point would be not to change policy in the sense that that purchases insurance against upside risks. All that said, I don't think I will dissent over 25 basis points, but I think there are risks here and the risks pertain to whether or not we have that new world you described sufficiently in hand.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN MCDONOUGH. Mr. Chairman, on the basis of my earlier comments, nobody will be surprised that I think your policy recommendation is right, for the right reasons, and in the right amount. I don't think we should expect the market to be particularly pleased with our action. There is a fair likelihood that the market correction in both stocks and bonds will continue, partially because even though the market is erratic, some will think our move is not as big as they would like it to be. But more importantly, we are near the year-end, the markets are relatively thin, and people have some very large gains that they may well decide to realize so that 1995 will look like a good year for them. We might also have some additional stock selling shortly after the turn of the year. There does seem to be a fair number of investors who have held off selling stocks, or selling bonds for that matter, in the hope that the capital gains tax will be lower effective January 1, 1996. How much of that sentiment there is, nobody knows, but I believe that there is some. In my view, it is very important that we not do more than 25 basis points and that we not touch the discount rate because there is sufficient uncertainty that, even though I happen to agree that your hypothesis is likely to turn out to be right, I think we should proceed cautiously. While I am very much a member of the opportunistic school for achieving price stability, I am a near-fanatic believer in achieving price stability. I think that the 25 basis point move leaves our price stability drive very much intact.

CHAIRMAN GREENSPAN. Governor Blinder.

MR. BLINDER. Thank you, Mr. Chairman. I am one of those opportunists who think that we have the real funds rate too high. As you said, it's higher than it was at the peak of our tightening. I don't see a reason to keep it there. I hope you will allow me to agree with the reasons that you gave for lowering the rate without signing on to your brave new world scenario, which I am not quite ready to do. I do agree 100 percent with all your reasons--the level of real interest rates, a weaker forecast than that in the Greenbook, and the minimal inflationary dangers. I definitely want to underscore that we are quite fortunate to be sitting here on December 19--ironically, we are quite fortunate, but the country is not--able to take this action and disassociate it entirely from the budget negotiation process, which I think is a very good thing for the Federal Reserve. Do it now.

CHAIRMAN GREENSPAN. Anything on symmetry?

VICE CHAIRMAN MCDONOUGH. Symmetric is fine with me.

MR. BLINDER. Symmetric will be okay with me.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. Thanks, Alan. Not surprisingly I would prefer alternative B because I think we have the opportunity to move inflation and inflation expectations lower in the context of an economy that is continuing to expand generally in line with the 10-year moving average. I also feel very strongly that 3 percent inflation expectations are too high. On the other hand, I can accept some easing of restraint. My quibble is really with its timing and not so much with the direction in which we are moving. I think the stance of policy will still be somewhat restrictive with a 25 basis point reduction, and such a reduction could well be consistent with lower inflation. I think the risk, and you put your finger on this, has to do with how our actions are perceived. People could well ask whether we are committed to long-term price stability or preoccupied with short-term considerations relating to the real economy. The statement you read that would accompany this action is very significant in terms of not mentioning the real economy. In fact, I had a comment on the minutes for the November meeting that I passed on to Don and Norm; we had almost two pages of draft text with respect to the policy decision last time before inflation was mentioned. So, no matter what we say in that statement, for a lot of reasons the perception is out there and will be out there that we are moving in part in response to concerns about the real economy. I would strongly object to any move greater than 25 basis points now or one that involved a cut in the discount rate for the reasons you cited. I agree that an advantage of moving now, though not a reason, is to emphasize the absence of any short-run linkage between monetary policy and fiscal policy negotiations.

CHAIRMAN GREENSPAN. President Broaddus.

MR. BROADDUS. Mr. Chairman, I won't say anything about the budget, but I might just mention the economy in passing. I think your longer-term vision of what I would describe as a permanent or at least persistent positive supply shock is an appealing hypothesis and may well be a valid one. But in talking about today's policy decision, I am taking a little shorter-run point of view. Clearly, one can make a case for some easing this morning; I don't deny that. But on the bottom line, I would come out with Cathy and Tom, as I am sure will not be surprising. There are risks in taking this action now. There is a risk that we may send a message, at least to some people, that we think the economy still has a good bit of room to run even though we had a very strong third quarter, and we may well find that we have a relatively strong fourth quarter when the figures come out. I feel there is a risk that they could undermine our credibility at a time when we may well be on the verge of a breakthrough in our quest for price stability. I mentioned in my economic statement that I think the current situation and the very short-term outlook are unusually uncertain. I know one can always make the case, and sometimes it's made too frequently, to wait until the next number or the next batch of data, but to me that argument seems more compelling in this situation than normally. Against that background, I think our best move today is no move. The economy's strength in the third quarter, the likely possibility that we will get another strong quarter in the current quarter, and the economy's proximity to something like potential GDP all argue to me that it's better to wait at this point.

CHAIRMAN GREENSPAN. Governor Lindsey.

MR. LINDSEY. Thank you, Mr. Chairman. Having dissented in favor of ease last time, I am reminded of Governor Blinder's basketball coach. I certainly support your recommendation. I also support your view that there should be no mention of fiscal policy in our statement, but I do think that in fact there will be some linkage made and in this case an unfortunate one. We would have been much better off to have moved in November. Also, I don't think we should pretend that we in fact ignore fiscal policy in our actions. To do so would be silly. The government is one-third of the economy. For us to ignore the actions of one-third of the economy, well, we don't do that. If there were a 10 percent cut in government spending or a 10 percent tax increase, would any of us say that we should hold the nominal fed funds rate the same? That is just preposterous. I don't think that was what is implied; we certainly pay attention to fiscal policy. I would give those two cases as examples of demand shocks where we clearly should respond. There is also a question about government causing a supply shock. For example, if the government were to raise the minimum wage to $10 an hour, that would be an adverse supply shock. If I followed Don's outline, trying to be symmetric in following your logic, we would respond to that with a cut in interest rates. It's an adverse supply shock.

MR. KOHN. I don't think the Committee would want to cut rates in that case.

SPEAKER(?). No, a rise in rates.

MR. LINDSEY. A rise in interest rates, yes. So, we should make ourselves even more miserable! I think this sort of analysis tends to break down, and that's why I have problems with the difference between a demand shock and a supply shock. Basically, when it comes to government actions on the supply side, I really don't think that we should get in the way. I think that's particularly applicable to what I am afraid may be the response next year to our action today. There was a major bond market rally this year in large part because of an expectation that the out-year federal deficits were going to be reduced substantially. If those reductions do not come to pass, and according to reports yesterday's stock and bond market corrections were in large part linked to the first realization on Wall Street that such reductions may not materialize, we may have a backup in intermediate and long rates. If that were to happen, I would view that as an adverse supply shock. Government is doing something stupid and the markets know it. Therefore, there is less confidence reflected in the price at which the markets are willing to lend to the government. If that were to occur, I don't think there is a lot we could do to undo it. So, I will look forward between this meeting and the next meeting to see what happens on the intermediate- and long-term portions of the yield curve. If in fact we get a backup, I think it is going to be very difficult to make any further easing moves. Thank you.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Thank you, Mr. Chairman. First of all, Don, let me say that I appreciate your effort here in looking at opportunistic versus deliberate strategies. I found this very helpful. I understand better what I meant! [Laughter]

MS. MINEHAN. I'm glad you do, Gary! [Laughter]

MR. STERN. Maybe I'm the only one. Just to talk a minute about that, I do think the opportunistic approach is the one we ought to follow. I say that because as I understand the evidence and given the quality of the evidence, and both may be flawed--that is, my understanding and the evidence [Laughter]--it doesn't suggest that there are big gains in taking inflation from 3 percent to 1 percent or something like that. If that's true, we should not want to pay a very big cost to do that. I think that comes out in favor of an opportunistic approach. Having said that, it may surprise you to learn that I favor no change in policy at this meeting. As I commented earlier, while I believe that we may get a soggy quarter or two because of the inventory situation, there is nothing at the moment we are going to do about that with a policy change. As I look out further into 1996 and 1997, I am hard pressed to see cumulative weakness in the economy. I am hard pressed to see a significant problem that I can identify. Yes, there can always be shocks; yes, I recognize that there are risks, but I think there is a good possibility that something like the Greenbook forecast will be realized. Maybe real short-term interest rates are on the high side. but I guess I am not entirely persuaded of that. Even if they are, perhaps that will reveal itself in lower inflation rather than anything else. So, at this juncture, I would favor "no change."

CHAIRMAN GREENSPAN. President Moskow.

MR. MOSKOW. Mr. Chairman, I really appreciated your discussion of longer-term trends. You discussed some of them in your talk when you were out in Chicago, and I think that has been very helpful. My preference actually is to wait at this meeting and not to move today. To quote Mike Prell, growth is not steady and we had a very strong third quarter and it could be that the sogginess we see in the economy now is just some slowing down from that quarter. I don't see any urgency to move today as opposed to the next meeting, and I think the 25 basis points symbolically is extremely important, even though it's not 50 basis points. I should add, however, that I don't feel strongly enough to dissent. I think, as Larry Lindsey said, that there will be some linkage to the budget discussions that are going on now, although that was not even mentioned in any of our discussion earlier today. I agree that it is very important in the press release you are suggesting to relate our action to receding inflation and declining inflationary expectations. I certainly would not want to change the discount rate. I agree with the symmetric language proposal as well.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, I don't believe that a rising real funds rate is warranted at this time. Also, our nominal income targeting rule that we follow calls for a cut in the funds rate of about 25 basis points. Therefore, I favor your recommendation and also the symmetric language you proposed. At least in terms of the work that my staff has done, it is quite possible that we may have to reverse that reduction sometime in 1996 if we maintain our longer-term price stability objective. As I think I indicated in July, clearly a move down at this time should be accompanied by the recognition that it may have to be followed by a move in the other direction at some later time.

CHAIRMAN GREENSPAN. Governor Phillips.

MS. PHILLIPS. I can support your recommendation for a small easing move, but I don't think that the case is very strong; we could wait. The economy is growing; the stock market is strong; the Wall Street Journal says we are off the hook; and the shrimp index is up! But we are behind the yield curve, perhaps by 50 to 75 basis points. We are getting mixed reports on demand, which to me reduces the chance of an upside breakout. I think the range of potential outcomes on the fiscal situation has narrowed, and I agree that we should not be holding back until there is a resolution. In fact, a move today would clarify that we are in fact taking into account the overall economic situation and not tying ourselves or being tied by a particular budget situation. To me the crucial thing is the inflation experience. It is much improved. I think there is a good chance, that inflation may not pick up, at least in the near term, given the slackening growth in demand, the increases in capacity, the international competitive pressures, and the labor market flexibility that we have talked about. Maybe this is the time to seize the opportunity, and I don't see that there is much reason to wait. If we go ahead and move today, then I would think that a symmetric directive is appropriate.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I certainly support your recommendation. As I said earlier, I see no strong pressures for a change in monetary policy at this moment one way or the other, and under those conditions my normal instinct would be to not move. I think the risks are symmetric and relatively small at this point. But of course we know policy does work with a lag and as this expansion continues to mature, I think the risks are more likely to turn to the down side as time goes along. As a consequence, I can support 25 basis points as a useful and modest move. I certainly concur with the spirit of your proposed statement.

CHAIRMAN GREENSPAN. Governor Yellen.

MS. YELLEN. Mr. Chairman, I support your proposal. I think we have good reasons to feel pleased with the performance of the economy over the last 18 months. Our job now, as I perceive it, is simply to enable these favorable trends to continue. For the reasons that I have already enumerated, I think the current level of the real funds rate is on the high side. It is arguably higher now than it was last February--as you mentioned, Mr. Chairman--given the decline in inflationary expectations. I think this poses a danger to the outlook, not in the short run, not over 1996, but over the longer term even though I recognize that that is a difficult call about which reasonable people can disagree. Nevertheless, having made that call I think that monetary policy should be forward-looking when we are lowering interest rates just as we are when raising them. On the fiscal policy linkage issue, it seems to me that acting today rather than waiting for a budget deal to be completed will enable us to mitigate at least to some extent the unfortunate public perception of a Fed that plays budget politics by holding out rewards and punishments related to progress on the negotiations. Although having said that, I certainly agree with what Governor Lindsey said. Fiscal policy matters to the economy and, of course, we cannot ignore fiscal policy linkages in deciding on our own policies.

CHAIRMAN GREENSPAN. President McTeer.

MR. MCTEER. I agree with the proposal.

CHAIRMAN GREENSPAN. President Hoenig.

MR. HOENIG. Mr. Chairman, I would prefer that we not change the funds rate right now given the projections of our economists in

Kansas City and in the Greenbook. However, given that we are talking about a small adjustment and given that there would be the expectation, which I would fully endorse, of no discount rate change, I can accept your proposal at this time.

CHAIRMAN GREENSPAN. President-elect Guynn.

MR. GUYNN. As my earlier comments suggested, I prefer alternative A. I think 25 basis points and a symmetrical directive are the right construct. I don't think I can add to the arguments that already have been made and will spare you a repetition of those arguments.

CHAIRMAN GREENSPAN. President Jordan.

MR. JORDAN. Mr. Chairman, I think that over time the evidence will accumulate that your hypothesis is correct. I am concerned that that evidence will accumulate very slowly, judged in terms of being persuasive to everybody within the System and to others who need to think about these things. The slow but eventual acceptance of the evidence and the hypothesis means that policy ultimately, ex post, will be viewed as having been too tight for the evolving conditions. I support the move today, but I think we need to be prepared to be a little more aggressive.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. It's in times like this that we wish we had measures of the money supply and reserves that would accurately reflect the stance of monetary policy. I think if we did, it would clearly show that there has been a tightening of policy. But we don't have those measures, and we are stuck with the federal funds rate. There is a long history around this table of using and abusing a federal funds rate target. I think what we are doing today is the right thing in terms of using the fed funds rate and making discretionary adjustments when it is necessary to avoid the pegging problem that we have had so often in the past. So, I think what we are doing here is the right thing. This is not the time to be tightening policy. Your admonition about referring to the budget is well taken. I must say, as others have said, that I have been increasingly uncomfortable in recent months about the perception that there is a tight link between what we do in the Fed and what happens on the fiscal policy front. I think it's important that that link be broken. I also agree with you that this ought to be a cautious move. There is enough uncertainty about the economy. I think the asset inflation problem, the bubble effect, is one that we ought to take into account. Our announcement ought to be couched in terms of a reduction in inflationary expectations. I agree that our action should be a 25 basis point reduction in the federal funds rate with a symmetrical directive and no discount rate change.

On the issue of opportunistic versus deliberative, I think it should always be clear in this discussion that whether one takes the opportunistic road or the deliberative road, the commitment to achieving price stability is absolutely firm. I don't think there is any difference in the commitment between those who adhere to one process or another. We need to be clear about that. My own view is that the opportunistic approach is the preferred one mainly because it works. There is a practical history to it, and I think that there is a practical future to it. While we are independent, what we do has to make sense to the country as a whole. I think the opportunistic approach will get us to price stability, and I think it will be a more acceptable approach broadly.

CHAIRMAN GREENSPAN. Thank you. There is a consensus for a 25 basis point decline in the funds rate and a symmetric directive.

MR. BERNARD. The wording of the operational paragraph is on page 15 of the Bluebook: "In the implementation of policy for the immediate future, the Committee seeks to decrease slightly the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, slightly greater reserve restraint or slightly lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman McDonough	Yes
Governor Blinder	Yes
President Hoenig	Yes
Governor Kelley	Yes
Governor Lindsey	Yes
President Melzer	Yes
President Minehan	Yes
President Moskow	Yes
Governor Phillips	Yes
Governor Yellen	Yes

CHAIRMAN GREENSPAN. The next meeting is January 30-31, 1996, and I now move to adjourn.

END OF MEETING